Beyond Wall Street Episode 22: Juan Alva, Pelham S2K

Jan Brzeski: (00:00:00)
Welcome to Beyond Wall Street, presented by Arixa Capital, where expert investors make their unique investment strategies easy to understand. I'm your host, Jan Brzeski, and today I'm talking with Juan Alva of Pelham S2K. And we'll be discussing the strategy of lending to businesses backed by private equity firms. Juan Alva, it’s great to have you as a guest for our interview series and nice to see you.

Juan Alva: (00:00:27)
Nice to see you, Jan. It's a pleasure to be here today.

Jan Brzeski: (00:00:12)
So, as you know, our audience is very interested in different private investment niches. And I'd like to start out by having you- hang on. We're going to have to start over again because I had noises and so we're going to edit that out. All right. Juan, it's great to have you as a guest for our interview series, and nice to see you.

Juan Alva: (00:00:34)
Nice to see you, Jan. And it's a pleasure to be here today.

Jan Brzeski: (00:00:31)
I wanted to start by focusing in on our audience, and they're always very interested in learning about new investment niches, especially in the private markets. So, if you could start, why don't you tell us a little bit about the kinds of investments that you're making?

Juan Alva: (00:0:47)
Sure. I would be happy to do that. We’re industry agnostic in our investments. So we'll look at deals in a variety of different areas. But we predominantly focus on business services, health care, and franchise businesses. And in that latter category, I can give you an example that probably a lot of people know about. We invest in a company called Planet Fitness. We provided the debt financing for private equity firm to acquire that business.

Initially, we grew our debt facility to allow it to go from 14 units to build new units and acquire others and to get to about 42 units. By the time that we were refinanced out as it did a strategic deal, that company is still growing today and doing very well. And so those are the types of businesses that that we like to support. It's really companies in the lower middle market that need growth capital and we're able to provide debt and some equity to help support that growth.

Jan Brzeski: (00:01:49)
Great. So using that example, you provided debt financing. Were you the only debt on the company or was there more than one lender? And where were you in the capital stack?

Juan Alva: (00:02:03)
Sure. So, the vast majority of the deals that we do are what's called unit tranches. Almost all of our portfolio companies are unit tranche investments. And what we do there is we find a deal will partner up with a bank, typically, and then we'll divide up the debt stack, if you will, into two pieces. It's one single debt facility, one single set of documents. So, the equity sponsor likes that, the company likes that. They have to make one wire or one payment when interest is due. But we're able to partner with a bank to take, let's say, the first part of the structure of the first half, and we'll take the bottom half. And so that's the way that we can not just provide the full financing need for the business, but we're also able to get the returns that our investors expect from our investment capital.

Jan Brzeski: (00:03:00)
Okay, terrific. So let's walk through that. What's the typical range of the whole loan, the unitranche, including the bank portion and your portion? What's the dollar range for most of your loans?

Juan Alva: (00:03:15)
Sure. Most of our loans will go up to $50 Million between us in a bank. And to give you a sense of how we divide it up, let's say a transaction is $25 million. Maybe we'll have the bank provide 60% of that or 15 million, and then we'll provide $10 million. The company will make one

interest payment, as I mentioned, but the bank will take a lower return. And so we will take what's remaining, and that's how we generate the higher yield for our investors.

Jan Brzeski: (00:03:54)
Okay, great. So I know, Juan, from our prior conversations that you also use some structural leverage within your part of the investment as well. So using your example, it was a $25 million loan. You had a $10 Million piece of that loan. What percentage of that of that $10 Million piece is coming from you and your investors? And then, where does the rest of it come from?

Juan Alva: (00:04:22)
Sure. So, the way I think about it is on an overall fund basis, what we do is we raise capital. We're an SBIC fund, small business investment company. And so what we'll do is raise private capital from our investors, and then we will apply for leverage from the SBA. So and the SBA will give us up to 2:1 leverage. So if we raise, let's say, $50 Million of private capital from our investors with 2:1 leverage, we can operate and invest like a 150 million dollar fund.

Jan Brzeski: (00:04:58)
I see. I see. So if I were to look at the whole loan that you made to the business, I can almost think of that as having three layers, one being the bank, which is sort of in the most secure position. And then the SBA is providing a portion of the junior peace, if you will. And you're getting a higher return because you're you're taking advantage of fairly low interest rate on those other two layers. Is that a fair way of looking at it?

Juan Alva: (00:05:31)
It's a bit different than that because what the SBA will do is they provide the leverage for the fund. And so it's across the board on the investments. And the SBA leverage itself is quite favorable. It's interest only for semiannual payments. So we'll make two payments a year interest only. There's no amortization. It's ten year paper. So it matches the life of the fund essentially, and then we can pay it down. You have to prudently pay it down, as you start getting paid back on your investments, you can start paying back your SBA leverage. And the way it works technically is, initially, they give us a draw and then the interest rate gets fixed a

couple of times a year by the SBA. They'll issue at a spread to Treasuries, which for a long time has been quite a favorable rate. The Treasury and it's off that the long term treasury, ten year treasuries. So that rate has remained relatively low. So it's a favorable financing structure for us. And this is a program that's been around for four decades. So it's, and the nice thing is also, for the US taxpayer, is that we don't rely on congressional appropriations. This program is self-reliance, is self-funding.

Jan Brzeski: (00:06:56)
Terrific. So. Let's turn to the risk side for a minute. What do you view as the top one or two risks of the strategy if someone wanted to make loans like this, and clearly, this is not a strategy that a layperson can execute on themselves. It's pretty involved. And you have to have a lot of pieces to put it together. But, what do you think would be the main risks that someone in this business needs to think about?

Juan Alva: (00:07:28)
Sure. I think it always comes down to a couple of big factors in credit. You have a private equity firm. We invest in companies alongside private equity firms. And so it's really the experience of the private equity firm. And as JPMorgan says, it comes down to character all the time. And so we are we're backing a business, but we're also backing a private equity firm. We're backing a management team. And sometimes, you know, I've seen things happen with a management team that there's turnover in the sea level officers sometimes sea level officer gets sick or passes away. It does happen, unfortunately, in this business. So you need to invest in alongside a private equity group that you think is going to be willing to dig into it. If there's a problem, you can never anticipate some shocks that happen with the business. We saw that in the pandemic and we work very closely with private equity firms. So again, going back to character, they need to have integrity. You need to have a good dialogue with them and trust that what they tell you is really what's going on. You work together. They need to trust you as well. I think you build a relationship and you really find out when things are going well. Everybody looks good. But when you hit a recession or you hit an unexpected bump, that's when you really find out what it's like to work with a private equity firm and with he management team.

Jan Brzeski: (00:09:13)
Okay. Let's talk about your business for a minute and the market that you're serving. Is it a growing market when you think about your own ability to deploy more capital over time? What are the factors that drive how much you can grow your own business?

Juan Alva: (00:09:27)
Sure. So deal flow is essential. But what we found is that the part of the market that we're in, small businesses, the lower middle market, these are businesses that need capital to grow. And it seems a bit incredible. But as the private industry, private equity industry has grown, the need for capital to support private equity. There's the, we put the L in leveraged buyout right, in LBO. And so it's essential to provide our capital our form of capital debt to help these businesses grow more efficiently. And that's why we partner with private equity firms. And so, as more companies have seen and that the private markets are able to provide the capital need and they don't need to go public necessarily, the need for our capital has grown as well. And so you've seen that in a lot of growth in different parts of the private credit market. And after the financial crisis in particular, when the banks pulled in 2008, 2009, when the banks pulled back, the need for private credit only increased because we have more flexibility. We have to be prudent in our underwriting and our investments. We're still responsible for our investors' capital, and we take that responsibility very, very seriously. It's not just the return, but it's the protection of their capital as well.

Jan Brzeski: (00:11:15)
So when you win a new loan, are you typically taking the spot that would have come from a particular group of competitors? Or is there sometimes that capital would actually come from a totally different type of source otherwise?

Juan Alva: (00:11:23)
Yeah, it's it's a bit of both. It is a very competitive market. The lower middle market where we participate is probably less competitive than the multi-billion dollar, several hundred dollar million up loans. But nevertheless it is competitive. There are some terrific players there very with very long experience in the market. And so part of it is we have to beat out a competitor. But the other part is also: where else would would this capital come from? Maybe. And this is

kind of the essential part of our business. It's possible that a private equity firm looks at something and says, okay, if we if we could get a little bit more debt capital on this, it feels like it's going to generate the right return for our set of investors. So sometimes we say, okay, we can we can add another couple of million dollars there of debt capital instead of having it be equity. Or maybe we do a layer of preferred between the common equity and the and the debt. And so there's every deal to some extent is not cookie cutter. We can add some bespoke type of financing structure to it. And what we like to do is say, okay, what does this company need not just to get the deal closed, but to grow? And that's the part where we can be a bit more creative and say, okay, here's how I think we can provide capital not just today, but in the future. Here's the path to provide more capital, so that the business can continue to grow.

Jan Brzeski: (00:13:05)
And then they don't have to go and get a new lender. When they execute on their business plan, they can continue to work with you and the bank that's part of your group. By the way, I have a question back to the unitranche and the bank participation. Who is servicing that loan? Is it the bank that's collecting the interest payments and then distributing your portion to you, or is it some other way of servicing it?

Juan Alva: (00:13:15)
Yeah, the payment will go. It's one wire, it'll go to the bank and then we have something. We have an agreement behind the scenes with a bank called an AAL, an agreement among lenders. And basically that document describes a relationship. When the loan payment comes in, the bank gets their portion, we get our portion. And that really governs the relationship between us. And as it amortization will go to the bank, for example, if there's a cash flow sweep, how that's treated, when you don't like to get into this. But if there is a problem with the business, how is that handled all that's in that agreement among lenders? But that's behind the scene. And it's a more versatile or easier document to go through then an intercreditor if we were in a senior mezz type of structure.

Jan Brzeski: (00:14:23)
Okay. So let's switch gears now to you and your career. And if you could just give our audience a brief background about your career and how you got focused on the area that you're lending into right now, that'd be great.

Juan Alva: (00:14:39)
Sure. Sure. I started my career. It's been 30 years since I graduated from college. So I started my career on the investment banking side at Goldman Sachs and spent seven years there and really learned a lot about M&A and financings, equity financings, debt financing, high yield, all kinds of things there. I took a bit of a detour after my time at Goldman, went into the tech sector, probably not great timing. That was around the time of the dotcom issues in 2000 to 2002. But I was CFO of a wireless software company and that was a pretty interesting way to learn about an entrepreneurial business. And I really caught the entrepreneurial bug. So I moved to the buy side, if you will, to the credit side and direct lending in 2007. And that's when, you know, at the time in a private fund that we did a BDC, which a business development company, which is another form of lender with with permanent capital in that structure. And so I've been in the business, we're at a new firm now, but I've been here about six years since 2016, but have stayed on the credit side, on the direct lending side and really with in the lower middle market. I really like providing the financing for these types of businesses. You know, when I was at Goldman, I got to work with some big names, household names like Polo, Ralph Lauren and Disney Company. But, you know, and we got access to sea level officers and that was pretty exciting. It's fascinating to see all the different types of small businesses that are out there. And I think it's personally extraordinarily satisfying to be able to have a positive impact on the employee base. And we take great pride in the fact that we supported all our businesses. We worked very hard through the pandemic to ensure their survival, working with the sea level officers, talking to the private equity sponsors, providing our own guidance and managerial assistance, which you need to be able to provide as a small business lender. I sit on a board now for one of our businesses and has it been easy with inflation and labor issues, really focusing on that and helping the business grow, helping you get out of difficult times? I think it's incredibly satisfying and so forth.

I'm 30 years into my career, as I mentioned, I'm closer to the end than the beginning. But I think it's a great place if someone wants to work with entrepreneurs and they're young and they want to help grow businesses and the economy, I think it's a terrific place to look into lenders, direct lenders, small business investment companies, SBIC as we're called. I think those are great areas to look for a career in.

Jan Brzeski: (00:18:40)
Okay. In my last question, which the question I get a lot about our funds is interest rates are moving, they're moving up. What does that do to your business model?

Juan Alva: (00:18:49)
Sure. So all of our loans are floating rate. And so we had the philosophy many, when we started this, when we said, hey, we want to be able to give our investors protection on the downside. So we'll have floors on our rates, but also give them some upside in the businesses that we invest in. And we do that with having a floating rate loans for a long time. It really hasn't come into play. The floor has been the most relevant anchor on the rates, but also the benefit of being a small business investment company and having leverage from the SBA. As I mentioned earlier, that gets fixed a couple of times a year. So, in a rising rate environment like what we're seeing, our investors should have the expectation here that they will see enhanced returns as rates step up. Now, it could slow down the deal environment. So that's the other side of it. And it could add to the burden of the of the companies that we're invested in, because they would have to pay more interest. But that's something that, again, we have to monitor carefully. And for our investors, I think it just gives them a good product that gives them a nice return in a regular environment, in a rising rate environment, gives them some upside.

Jan Brzeski: (00:20:11)
Juan Alva, thank you so much. I really enjoyed it and I learned a lot. Really appreciate it.

Juan Alva: (00:20:18)
It's my pleasure, Jan. Thanks very much.

Jan Brzeski: (00:20:32)
I’m Jan Brzeski and you’ve been listening to Beyond Wallstreet.