HARBERT MANAGEMENT CORPORATION

Seek and deploy

As the number of private debt funds entering the market increases, many are increasingly looking at more specialised strategies. Harbert explains to **David Brooke** why its long track record of investing in European high-growth companies and the US mid-Atlantic gives it the edge

Johan Kampe

Harbert Management Corporation (HMC) is an alternative investment firm founded in 1993 with private debt strategies on both sides of the Atlantic. Approximately 20 percent of HMC's $4.5 billion in regulatory assets under management (as of 30 August 2016) is from the firm's 21 shareholders or partners, invested on the same terms as other investors. With Harbert European Growth Capital (HEGC) focusing on lending to innovative small and medium sized enterprises across Europe, and Harbert Mezzanine Partners (HMP) targeting similarly-sized firms across the southeast, southwest and mid-Atlantic regions of the US, HMC has shown how a sharp focus on specific areas of the private debt markets can achieve strong, risk-adjusted, cashflow-generating returns.

In January 2013, HMC partnered with David Bateman and Johan Kampe, who have almost 40 years of combined experience investing in high-growth companies across Europe, to launch HEGC. HEGC invests across Europe into companies backed by private equity sponsors. The HEGC team, now numbering nine professionals in London, is preparing for the launch of its second fund, having completed already over 40 deals.

HMP, launched in 2000 and managed from Nashville, Tennessee by John Harrison and his team of eight professionals, targets US lower-mid market opportunities. Since inception, Harrison and his team have completed approximately 100 transactions totalling circa $600 million, with deals ranging between $5 million and $15 million, typically structured as five-year term, interest-only junior debt plus equity and/or warrants. Many of their borrowers are service-oriented businesses with strong cash flows, planning organic growth, acquisitions, recaps or management buyouts. Harrison expects to be back in the market with his fourth fund early in 2017.

HARBERT EUROPEAN GROWTH CAPITAL

Q What is your investment strategy?

We're interested in high-growth companies that are based on innovation. These firms have higher margins and growth rates than the economy generally (think 50 percent-plus gross margins and 25 percent growth rates). As such, they are going to be valuable to acquirers, but frequently show accounting losses and negative cash flow when we lend to them due to heavy investment in sales people and research and development. Since the bulk of their assets are intangibles, they are generally neglected by the banking system.

We provide three-to four-year loans to these companies, long before the banks would lend to them and in larger amounts.

David Bateman

Q Why is Europe an attraction for your fund?

If Europe is rich in one thing, it's jurisdictions. This alone makes our capability to allocate capital across 15 jurisdictions a key tool in generating attractive risk-adjusted returns.

Also in contrast to the US, the European technology and innovation landscape is dispersed. European companies spring up in many different places. Munich, Stockholm, and Cambridge have all produced billion-dollar unicorns in recent years. This reinforces the value of a pan-European approach.

Finally, while European private equity and venture capital investment has recovered from the nadir of 2011, it remains relatively weak compared to the US. Between 2011 and 2015, European venture investment increased from $5.1 billion to $14 billion. However, during this same period US venture investment increased from $37.6 billion to $75.4 billion, and remains vastly greater. For European growth companies, equity capital remains relatively hard to come by compared to the US.

Q What do your investments look like?
All of our investments are high-yielding secured loans with separate (free) equity kickers attached in growing companies, generally over-collateralised with respect to enterprise value. Our loans are cash pay with negligible amounts of payment-in-kind interest and amortise to zero over 3-4 years. Because of the underserved nature of our space, we are usually the most senior instrument.

Q How can you help pension funds offset their liabilities?
Harbert European Growth Capital Fund I is paying a running cash yield of approximately 7 percent annually. Our current realised asset-level returns considerably exceed this figure. As the equity kickers mature, we are targeting even higher overall returns (net IRRs of 13 to 15 percent). We should be an interesting option for any debt investor who wants yield; note we do not use leverage.

Q How have you protected yourself against Brexit?
We believe Brexit is going to exacerbate the cross-border difficulties the European banking system faces, which should be good for those like us who lend across borders but don't use depositors' money. As long as Brexit does not put an end to innovation and e-commerce, we don't see it as a major risk.

HARBERT MEZZANINE PARTNERS

Q What is your investment strategy?
We look to invest in companies that are profitable and meet our more traditional credit underwriting criteria. We don't amortise our loans and they are typically five-year maturities. We have a coupon of 12 to 14 percent, creating current income that is distributed to fund investors on a quarterly basis. All investments have an equity ownership component through either a warrant or an equity investment.

Q Why should pension funds be interested in the fund?
With pensions having issues with fixed income returns in the current rate environment, our strategy offers a portfolio of loans that have a higher yield than can be generally achieved in the fixed income markets. There is no leverage deployed at the fund level and those earnings are distributed to the investors on a quarterly basis. All of our loans have some type of equity ownership and while it's a great yield enhancer, it's also a great capital preservation tool. When a transaction doesn't work in the way expected then you've got a number of equity positions in other companies that are going to bring positive returns to offset any negative results.

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John Harrison, HMP

John Harrison

Q What is the attraction of the lower mid-market?
When you look at the amount of capital available to invest in this market there are a lot of small funds, but a lot more companies as compared to the larger markets. Entry multiples also are more attractive and it typically is easier to achieve higher growth rates in these smaller companies; if you look at the annual M&A league table almost 80 percent of the transactions are under $100 million in enterprise value.

The downside to this market is the transactions are smaller, which effectively caps fund size. As a result, it appears the maximum fund size for this strategy is too small for many of the larger multi-strategy alternative asset managers.

Our transactions are primarily unsponsored, meaning there is no private equity firm with equity below us. Sponsored market returns are typically lower than what we want or think is the proper risk and reward for this type of transaction. The downside to this is there is no one else to rely on when there is a call for more capital so we have to basically take that sponsor's role. We source deals through an eclectic network of people in the deal universe that we have built over the 20 years or so that we have been investing in this strategy. ■