Rainmaker PODCAST

SEASON 3 EPISODE #2

ERIC GREEN

PENN CAPITAL

Gui Costin: What is up, everybody? Gui Costin, founder/CEO of Dakota. Welcome to the latest episode of The Rainmaker Podcast. I'm joined by Eric Green, CIO of Penn Capital. Eric, welcome.

Eric Green: Thank you.

Gui Costin: Thrilled to have you here.

Eric Green: I'm excited to be here.

Gui Costin: So, Mr. Green has been with Penn Capital since 1997. As CIO, he guides the firm's equity and credit strategies. He also serves as a senior portfolio manager for Penn Capital small-cap, small-to-micro, and small-to-mid-cap, and mid-cap equity` strategies. As a member of the Equity Risk Committee, he works closely with the equity portfolio management team, to contribute ideas, specifically in the micro- to mid-capitalization range. Before Penn capital, Mr. Green worked at the Royal Bank of Scotland and the United States Securities and Exchange Commission as a financial analyst in the Division of Investment Management. He's also the vice chairman of the board of directors for the Anti-Defamation League, Mid-Atlantic Region, and previously served as a co-chairman of the ADL's 2018 Walk Against Hate. Mr. Green earned a BSBA cum laude from American University and MBA from the Yale School of Management. So, I've known you for a long time. Been following you. A very talented small-cap manager. Before we dig into it, could you go through just give us a little overview of yourself, your background, and then Penn Capital, we'll dig into the interview.

Eric Green: Sure. I started at Penn Capital when we had eight people, $100 million under management. That was in 1997. So about 28 years ago. I came from Yale School of Management. Before that, I worked for the SEC. I saw an opportunity to work for a seasoned investment professional and learned the business in a small firm. Over the next several years, we grew the firm significantly. And we started new products. We managed a micro-cap, small-cap company, we call it... a strategy we call the smaller company strategy, and a small to mid, as well as high-yield strategies.

Gui Costin: Nice.

Eric Green: And manage about $2 billion in total assets.

Gui Costin: Great. So, give us... could you just discuss your approach to equity investments from a credit assessment perspective.

Eric Green: Sure. So, we're very different than the typical small-cap manager. Even the big firms that manage small-cap, they have a separate small-cap team, along with a large-cap team, a mid-cap team, as well as high-yield investment grade, and so forth. Unlike most, we, our team is all the same. So, all the analysts and the portfolio managers, we cover the entire capital structure of the companies we follow. So, if you take a big firm, like a Fidelity or something like that, they're going to have their high-yield people on the 50th floor, their equity people on the 20th floor, their convert people in San Francisco, their bank loan people somewhere else. With us, it's all the same person. So, our analysts and portfolio managers, they're industry experts and capital structure generalists. When they look at a company, they start with the top, the secured debt, the bank debt, the secured bonds, the unsecured bonds. The converts preferred all the way down to the equity. And we're looking for something in that capital structure, which we call a capital structure catalyst, that can create value for the equity. We're looking with on the equity side. Our portfolio managers are separate. So, I run the equity strategies. Joe Maguire runs our high-yield strategies. Also, Paulo Silva runs our micro-cap strategy.

Gui Costin: Great. So, when you... because you guys actually have, I think, trademarked this term, right, called complete capital structure analysis. Can you share with us the benefits of understanding the complete capital structure of a company.

Eric Green: Absolutely. So, most of my peers on the equity side are focused on similar things, like valuation, talking to management, looking at from an industry standpoint, trying to understand all those issues. What we're looking at also, we look at all those things, but we also look on the bond side. What is the credit market telling us about the opportunities in the equity side? A lot of times you see this disconnect, where the bond prices are going up, yet the equity is doing nothing. And a credit investor, we think of a credit investor as being much more risk averse than an equity investor. So, if a bond is going up, and the equity is doing nothing or going down, there's some type of disconnect that we want to investigate and maybe that's an opportunity in the equity. If you think about it, a bond trading at 99 has one point of upside and 99 points of downside. A stock at 10 has unlimited upside, 10 points of downside. So, equity and credit people look at things differently. We hire people, usually with just a few years' experience, to train them to think holistically about a company, the entire capital structure, and how the equity affects the bonds, how the bonds affect the equity. We like to say that we're better equity investors because we're credit investors, better credit investors because we're equity investors. A couple of things that differentiate us that are part of our competitive advantage. We're probably the only equity manager you'll ever talk to that could tell you the price of the bonds of the stocks that we own. So, as the bond price goes up, that makes us more encouraged about the equity because the cost of borrowing is going down. As the bond price goes down, maybe the equity is still running. The bond investor is saying, hey, things may not be that great, and maybe that's a signal that we should be trimming that stock. Our expertise in credit, yes, we own companies that have leverage, but our expertise in credit has allowed us, over my period, over 27 plus years, we've never had a bankruptcy in the portfolio.

Gui Costin: Wow.

Eric Green: On the equity side, I think in credit, we had one bankruptcy, which was my fault, about 15 years ago. There was fraud at the company. But almost no bankruptcies in the history of the firm on either side because of our expertise in credit. We were probably the only equity manager you'll talk to that can tell you the bank covenants and the credit facilities of the companies that we own. We're probably the only equity manager you talk to that attends high-yield conferences and talks to high-yield traders. And we're just gaining additional insight, which I believe every good small-cap manager needs to do things a little bit differently than everybody else. And we are focused on a different part of the small-cap market than most of our peers, because most of our peers are not comfortable owning companies with debt outstanding. And ironically, most people wouldn't believe this, but it is absolutely true. We have the numbers behind it. Companies with more leverage have a much better performance track record over the last 35 years. And we have—

Gui Costin: More leverage.

Eric Green: Companies with more leverage. So, the companies with the highest leverage versus the companies with the lowest leverage outperform considerably over the last 35 years. Now, obviously, there's a lot of volatility when credit spreads are widening out, when people are worried, the companies with leverage tend to get hit a little bit harder. But on the other side, they're up a lot more. And that makes up for those periods where there's difficulty. The reason for that is because the multiples and the valuations are much higher in those so-called high-quality, great balance sheet small-cap companies. Everybody wants to come in and tell you, I own these wonderful companies with great balance sheets, with defensible businesses, and good markets and bad markets, and have very straightforward capital structures. And nobody really wants to come in and say, well, I own companies that have capital structures that people are really concerned about and don't understand. But those types of companies, that's what we gravitate toward because we have this expertise on the credit side that can help us make sure that these companies are going to survive and get better. I am a big proponent of less bad. And so, if you go… if a company goes from having a great capital structure to a little bit worse, that's not good for the multiple. But if a company goes from a capital structure that people don't like, moving toward one that's more average, that can be a very powerful move in the stock. As that company's capital structure normalizes, and more investors get interested in that company as the leverage comes down. And we see a lot of opportunity there in this market today, and historically, we have.

Gui Costin: Got it. So, when allocators are considering a small-cap manager, how do you determine if they're-- because I think you're going to make a case that a lot of these people call themselves small-cap managers, but they're really not.

Eric Green: Sure. Yeah. Many small-cap managers… and some have fortunately closed because they should be closed… have gotten so big that they're really mid-cap managers masking as small-cap managers. They say they're small-cap. But if you look at the average market cap of companies that are invested in by small-cap managers in the Morningstar universe, the average market cap today is $6.2 billion. The Russell 2000 is only $2.5 billion, approximately. Our smaller company strategy market cap is about 1.9 Our small cap is about $3 billion. We want to be a true small cap manager because we are waiting. We've been waiting for a long time for small-caps to beat large-cap. So, when small-cap stocks ultimately, when that cycle turns, and it's been a long cycle, so we think there's a lot of reasons that we can go into why it's time for small-cap stocks. But when small-cap stocks start to beat large-cap stocks, you want to be in a manager that owns small-cap stocks. It owns stocks that are representative of the Russell 2000, not stocks that are represented of a mid-cap index, when there are $6 billion plus in market cap. And that's very important to us. And I think it's important for viewers and everyone to understand, when you're looking at a small-cap manager because you believe that small-cap is going to provide that diversification and going to give you that upside when small-cap outperforms, make sure you're buying a real small-cap manager.

Gui Costin: Gotcha. And makes a lot of sense, especially just as things have gone up so dramatically. So, give me the macro factors right now on small-cap valuations and where you see opportunity.

Eric Green: So small caps, depending on who measures it, have been underperforming large caps between 10 and 12 years. Historically, large-cap versus small-cap performance, outperformance goes in cycles that range from 7 to 10 years. So, we are at the very end. So, you have 7 to 10 years, where small-caps beat large-cap, then the next 7 to 10 years, large-cap beats small-cap. And it just... you have these cycles. We are at, I believe, the tail end of a cycle where large-cap has beaten small-cap. As I mentioned it's at the 10 to 12-year mark right now. But a lot of things have fallen in place just in the last 6 months, that would not only small-caps do but give very good reason why small-cap should start to outperform. And there's multiple reasons. The election was obviously a very good scenario for small-cap stocks for the following reasons. Deregulation is great. The benchmark in small cap is heavily loaded with banks and financials. Deregulation is great for the banks and financial sector. Deregulation is going to allow... there will be more mergers and acquisitions. In fact, around the time of the election, there was a 6-week period in the election... around the election, where we had 6 companies in our smaller companies' portfolio have some type of M&A announcement. Either somebody was buying them or they put themselves up for sale. All of a sudden, M&A is getting really big. And if we invest in a couple of investment banking boutiques. Amazing, if you look at those stocks, the stocks have done great, but M&A has been dead for two years. When you talk to these companies, they're going to tell you that the pipeline for deals is the best it's ever been. And there's a massive backlog. So, coming back to small-cap, small-caps are historically cheap versus large-cap. So, what better way to do M&A is for a large-cap company to buy a small-cap company. Lower rates, really big deal for small caps. And the amount of floating rate debt in small caps is about 45% of their debt is floating rate. The amount of floating rate debt for large caps is about 10%. So, the day the Fed cuts rates, immediately as an impact in the cost of borrowing, much bigger... four times the impact for smaller companies than larger companies. So that is a very big, positive, improved economic environment, improved by the sentiment, economic sentiment. All of that is good. And even some of the things that people are talking about as being really negative, small caps are somewhat insulated from tariffs. They're more domestically oriented. They're not importing tons of goods. The tax bill will be really good and even better for small-cap domestic companies, domestic-oriented companies. They're going to get the big tax relief.

Gui Costin: Is there anything else you want to mention just on M&A, in particular? I know you covered it.

Eric Green: Yeah. I would say that we typically, in our portfolio, we have a much higher incidence of M&A in the portfolio than most... than the index for most managers. And that's because we're buying companies that generate a lot of free cash flow. Pay down the debt, their debt over time. And the valuations are attractive. We tend to have a lot of that. In 2022 and 2023, we only had two acquisitions in our small-cap portfolio. We've averaged somewhere around six or seven every year. Two was the lowest we had ever had since I've been managing the portfolio. We had two for two years in a row. I expect that in '24, we have about 4 or 5. '25, I think we're going to get back to having 7 to 10 or more acquisitions in the portfolio. There's just a lot of reason for companies to do deals where the last couple of years, when one of the reasons when you thought that most deals are done, a lot of it is done with floating rate debt. So, when you're going out to look to buy a company, and the Fed keeps raising rates, and there's no end in sight to how much the rates are going to go up, you want to... the companies that are looking, they want to know what their cost of capital is going to be. So, they don't want to buy a company, do the modeling, and say, oh, all of the sudden rates are going to be much higher. So, they wanted certainty that rates weren't going to go higher before they started to put out their capital. And now we know, the rates have already gone lower. They're not going back up for foreseeable time, and likely to go down a little bit more. So, it opens up the environment of the acquirer or gives them much more confidence in doing deals today and being able to value those deals going forward.

Gui Costin: That's fascinating. Wow. So, talk to me about this interoperability of private equity on small-cap companies.

Eric Green: Yeah. Look, I have always had a little bit of a chip on my shoulder because they get paid 2 and 20, and we get paid a lot less. If you look at the long-term history of our strategy or even just micro-caps in general, they actually outperform private equity micro-cap stocks. The problem is with public long only liquid equities, you could put money in at the very top. And you could sell at the very bottom. With private equity, they just hold your money until the very end and give it to you. But there's very, very similar type companies in the micro-cap and small-cap universe as there are in the private equity universe. What I find interesting today is deals are getting done in the private markets at multiples that are higher than in the public markets, which makes no sense to me, because why should a company be valued more in the private market when they're illiquid and versus a company that you buy and sell every day in the public market. So typically, public companies traded at 20% to 25% premium to private companies. Today it's the opposite. So, a lot of money going into large cap making those valuations very expensive, relatively small. A lot of money going into private equity, making their valuations very, very high relative to small. Historically, that money going into private equity, I believe a lot of that money is end up being used to buy cheaper small-cap companies that are out there. We have very many similarities. We... actually our strategy is very similar to what private equity does. We just do it in the public market. We buy companies that have more leverage in the market really appreciates. They generate free cash flow. They pay down that debt. Their leverage comes down. They create equity value by paying down that debt. And ultimately, their valuations go up. What a private company does is they make an acquisition, usually, of a public company. They lever the hell out of the company. And then they pay that... they use the free cash flow to pay down that debt over time, create equity value, take it public, sell it to one of their private equity buddies. That's what they do. So, we actually do this exactly what they're doing. We just do it in the public market for everybody to see. We got to deal with the ups and downs every day of the equity markets. But we are very much doing something very similar, our process. I can also say, in fact, I met with the... years ago, I met with the CFO of Apollo. He came in when they were doing their IPO roadshow. And I said, hey, just for fun, here's how we do things. And I said, what do you think about that? And he said, you're doing exactly what we're doing. You're just doing it in the public market. I said, how do we get paid like you do? How do I get 2 and 20.

Gui Costin: Yeah, exactly. I hear you. So, talking about some of the subsectors that you find attractive in the small-cap arena.

Eric Green: Today, there's a lot of attractive areas in the market. One that I think has been overlooked and maybe starting to get a little bit of attention more recently is natural gas, and the energy sector in general. And why do I say this? Because it's been... energy's been miserable the last couple of years. But all this excitement about AI and data centers and all... everything that we're going to be able to do in the next 5 to 10 years, is not going to be powered by wind and solar. What it's going to get powered by is natural. A lot of it is going to be natural gas, maybe a little bit of nuclear here also. But the amount of energy that we're going to need to produce for all these aspirational things we're talking about, that Google is talking about, and all these other companies are talking about, you're going to need to produce a lot more energy. Natural gas is much cleaner than coal, much cleaner than oil. People have called us the Saudi Arabia of natural gas. We have a lot of natural gas. We have so much that we're exporting it. We're building more export facilities, which means more is going to go out. We're going to have to produce more. And the companies that produce that natural gas will provide that infrastructure. They haven't run up in price like these other companies. Even some of the independent power producers have had huge runs and speculative runs here, on the assumption that there's going to be needing an enormous amount of power. Well, where do those independent power producers get their power from? They get it from natural gas in many circumstances. So, the companies that are producing the natural gas and the companies that are helping companies produce the natural gas should benefit considerably going forward. And I just think it's an interesting, overlooked area when everything else is doing great. The actual raw material to get that power is very much undervalued today, and there's a lot of opportunity in those areas.

Gui Costin: Got you. And the other subsectors that you like within small-cap.

Eric Green: Yeah. I think the consumer is... the consumer has always been underestimated. Now, everybody thinks, oh, the consumer is going to die. Things are going to go away. Everybody's going to get depressed. They're going to spend less. And then no matter what, they just keep spending and spending and spending. The consumer, also there's just a lot of bearishness generally. But the consumer is in great shape. They're like, oh, record amount of debt. But when you look at the amount of debt relative to income, it's actually not that high. It's actually better than it was pre-COVID, much better. So, consumers are in really good shape. So, I think spending is going to go up considerably. We like, one of the areas that really fits what we do is in the gaming sector. The casino sector, very steady business, particularly the regional business. These companies generate free cash flow. They pay it down. The consumer will continue to go to the casinos. They'll continue to go to restaurants. There are a lot of interesting restaurant ideas also that have been beaten down with just with this, that you had this big bump post-COVID because everybody went out and spent money and did everything. And then the stocks had big runs, but they pulled back considerably because the market was thinking, they'll never get back to where they were. And that was just a one-time thing. Now, their comps, their comparisons get easier, and the consumer is still there. And I think that there's going to be a lot of opportunities there with a lot of companies. Probably stay away from some areas in the consumer. Housing is going to be a tough one with higher rates. But leisure, entertainment, services, all look very attractive to us today.

Gui Costin: I love it. So, as we close out, talk to me about give me one key takeaway of your small-cap strategy and what the differentiation.

Eric Green: I think really, a key takeaway, one way to use Penn Capital is that we tend to zig when others zag. This was a shocking statistic that I read, that 95% of Morningstar's small-cap managers underperform the upside, and they get all of their alpha on the downside. So, most small-cap managers are so-called quality, high-quality small-cap managers, defensive small-cap managers. And we are the opposite. We're going to get all of our alpha comes on the upside. Because of the nature of we're buying levered equities, we buy a lot of cyclicals, it comes on the upside. We're doing our best to protect the downside. But that's not where we're getting the alpha. So, it makes sense to me is to pair a Penn Capital with one of those so-called high-quality managers, because we've done some analysis that if you did a 50/50 portfolio, and I won't name the small-cap manager, but there are a lot of them that would fit this with a defensive small-cap manager in Penn Capital. And rebalanced it every year, you would have much better and more consistent returns than the Russell 2000 itself. So, if you find a really good defensive manager and a really good manager that's more aggressive, then you will get by, you're going to get a better result than you would with just owning the index, or owning a manager that's close to the index. So, you want to diversify your small-cap portfolio, especially ones that have done well in this period where large has beaten small. We've actually had some statistics of how we do when small beats large, and we do way better in periods where small beats large cap than when large beats small. So, if we're in a period where you think small is going to beat large, you want to have exposure to a manager that can take advantage of that upside. And most of them, the way they're built, they're built to be defensive. You want to take that opportunity to strike while things are good and to have a manager that can do that. And I'll just say one more thing, because I joke around with my friends that manage high-quality small-cap portfolios. I tell them, what? Why would you ever run a defensive... why would somebody choose a defensive small-cap, or a high-quality small-cap portfolio? That seems like an oxymoron to me. The reason why you invest in small cap is to take advantage of that volatility premium than you're getting. So, you want to have a section of your portfolio that when small-cap's working, it's killing it. You don't want to have a small cap... you don't want to be in a small-cap manager that's trying to protect your capital when things are good. Small cap is meant as a piece of your portfolio to diversify it and take advantage of that volatility premium over time.

Gui Costin: Got you. Well, Eric, thank you. I can't tell you how much I've enjoyed the conversation. Love what you guys do and the way you articulate it, and answer the questions is really wonderful. So, thanks so much for being here.

Eric Green: Yeah, thank you. This was fun.

Gui Costin: Awesome, Eric. So that is a wrap for another episode of the Rainmaker Podcast. Eric Green, Gui Costin signing off. Can't wait to see you in the next Rainmaker Podcast.