HDC

HUNTING DOG CAPITAL

Private Equity by Default, Not by Design

A Discussion of Workout Strategies from a Direct Lender

Hunting Dog Capital has been a lender to lower middle market companies since 2004. From experience, we have learned that borrowers operating to plan is not the norm. Even with the most detailed diligence and rigorous underwriting processes, unforeseen or unanticipated events often necessitate the need for us to take action to protect our loan. In the best-case scenario, a minor amendment or waiver can be enough to enable a borrower to navigate an unexpected event or short-term issue.

Mo' Money

Sometimes, amendments or waivers are not satisfactory solutions. Often times, borrowers represent that additional capital can fix everything. More money may be part of the solution, but usually more drastic steps are required.

While every situation is unique, our experience has taught us that one common contributor to financial distress is the CEO's attraction to revenue over profit. Typical rationales include:

- "This gets us in the door. We will make it back over time."
- "Best we could do without losing the business. It is a competitive market."
- "It's the price you pay for being a small supplier."

Not having the systems in place to collect accurate and timely data to determine a pricing strategy to assure minimum profit contribution on every sale can be fatal. It is not uncommon for us to see our clients negotiating a price and not realizing they are losing money. Over time, there inevitably will be a covenant breach.

Take Action

We learned quickly that before a loan closes, you need a sound plan of action to minimize losses. Borrowers will always provide reasons and sometimes threats as to why a lender should stand still. When there is a loss of faith in the management, delay will only make a bad situation worse. When more drastic steps are required, a lender can pursue one of the following courses:

- Debt-for-equity conversion
- Foreclosure
- Receivership
- Bankruptcy (Chapter 7/11)
- Forced/Orderly sale

Selecting a course of action is dependent on each unique set of circumstance. Sometimes, the best decision is to do nothing. Losses occur when making risky investments, but it can be better not to compound the pain with more time and capital. Alternatively, and under the right circumstances, taking control of the situation, can not only increase the likelihood of recovering your investment, but also potentially generating a return well in excess of the original loan amount. In other words, private equity by default.

Private Equity by Default

A lender can take control through the remedies described above, such as a receivership sale, bankruptcy proceedings or a debt-for-equity swap. Each has advantages and disadvantages. For example, a receivership sale or bankruptcy will "cleanse" the acquired assets of past liens and most potential liabilities, but can be time consuming and expensive. While there is more certainty with respect to process, a bankruptcy or receivership can be extremely disruptive and uncertain for all stakeholders – employees, vendors and customers. Under a debt-for-equity swap approach, a lender converts a portion of its debt into equity of the borrower. Not only does this relieve the borrower of some, if not all, the debt service and is less disruptive to the borrower, it can also provide the lender direct operating control and the ability to instigate real change. Unfortunately, a debt-for-equity swap does not "cleanse" the assets and requires borrower cooperation.

When faced with the prospect of a lender enforcing its rights, borrowers/owners often threaten to quit, which they assure will cause irreparable harm because the employees will quit, customers will refuse to do business with the company and many other horrible consequences will transpire. While this can be true, our experience has been that the vast majority of employees, suppliers and customers prefer to work with stable partners that pay and perform as promised.

Before seeking control, a lender must consider the following:

- Are the challenges faced systemic or company specific?
- Is there potential to turn around the company and is it worth it?
- Is current management willing and able to make the required changes?
- What outside resources are required – legal, industry consultants, HR, recruiters?
- Can risks be properly identified and mitigated? In other words, as skeletons surface, can a lender adequately protect itself?
- What are critical first steps to enhance probability of success?
- The importance of messaging a common goal to all stakeholders – employees, vendors and customers

Case Studies

The following case studies are examples where Hunting Dog Capital gained operating control that not only saved almost 200 jobs, but also have the potential to generate returns well in excess of the original loan economics:

- Clean Water Environmental (Receivership sale)
- Pet Brands (Debt-for-equity conversion)
- Advantage Manufacturing (Forced/Orderly sale)

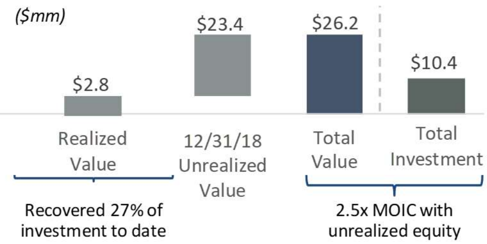
Clean Water Environmental - Opportunity to generate higher return through receivership sale

Investment Overview

- Clean Water Environmental ("CWE"), headquartered in Dayton, OH, processes hazardous and non-hazardous waste streams as well as recycles recalled airbag inflators
- Since April 2011, HDC has invested $10.4mm ($7.4mm loan) in CWE
- CWE defaulted and forced by HDC into receivership in June 2015
- HDC successfully credit bid and acquired the assets in September 2017. Since taking control, HDC has achieved the following:
  - Recruited former executive that designed and previously operated main facility as new CEO
    - Recruited new CFO and sales manager
    - Implemented standard operating procedures, including maintenance
  - Satisfied all outstanding issues with regulatory agencies to regain full compliance
  - Launched new business of shredding recalled airbag inflators
    - Developed proprietary and patent-pending equipment and process
    - Secured outside financing to purchase required equipment
- YTD (August) revenue growth of approximately 51.1%
- YTD (August) EBITDA margin of approximately 13.4% vs. -2.4% for the prior period

Recovery Analysis

Equity position provides meaningful upside



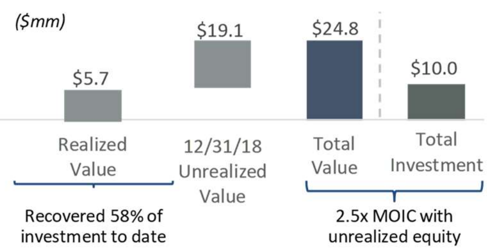
Pet Brands - Opportunity to generate higher return with debt-to-equity conversion

Investment Overview

- Pet Brands, headquartered in Dublin, OH, produces branded and private label dog and cat treats, toys and accessories
- Since June 2012, HDC has invested $10.0mm ($9.2mm loan) in Pet Brands
- Though current on its loan, Pet Brands was increasingly falling behind with its largest and most important supplier; current ratio below 1.0x
- In April 2017, HDC elected to swap 80% of its Note for an 80% ownership stake in the company. Since taking control, HDC has achieved the following:
  - Acquired remaining 20% ownership stake at a significant discount
  - Negotiated exclusive North American distribution rights for highest margin product
  - Replaced CEO with a well-respected industry veteran
  - All vendors have been brought back into terms
    - Current ratio of ~2.7x as of August 2019
- YTD (August) EBITDA up approximately 3.2x vs. 2018
  - EBITDA margin of approximately 11.6% vs. 3.9% for the prior period

Recovery Analysis

Equity position provides meaningful upside



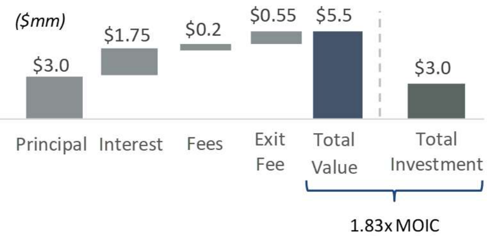
Advantage Manufacturing - Successful workout to enable orderly sale of assets to repay loan

Investment Overview

- Advantage Manufacturing Technologies, Inc., headquartered in Monroe, WA, is a contract manufacturer of precision-machined surgical implants and instruments for the orthopedic, spinal and dental industries
- HDC made a $3.0 million loan to AMT in February 2015
  - Trailing twelve-month EBITDA of approximately $432m at entry
- Though increasing EBITDA, poor management decisions resulted in significant balance sheet and liquidity constraints
- In April 2018, after amending the HDC loan and several failed attempts to refinance the debt, AMT defaulted on its repayment of principal
- To mitigate risk and increase the likelihood of a favorable recovery, HDC and AMT entered into a forbearance agreement along the following terms:
  - Chief Restructuring Officer retained to replace CEO/sole shareholder
  - HDC took control of all bank accounts and approved all cash disbursements
  - Weekly amortization of $7,500
  - Established three-member board with two HDC-appointed members
  - Retained investment bank to prepare and market the company for sale to repay HDC loan
- Under HDC's increased oversight and control, TTM EBITDA increased to over $1.1mm
- In June 2019, because of recently improved financial performance, AMT was able to sells its assets and repay the HDC loan, including all interest and fees
  - Estimated gross IRR of approximately 21.4%; MOIC of approximately 1.83x

Recovery Analysis

Forced Sale of Assets to Repay Loan



Lessons Learned

As a lender, sometimes doing nothing is the best option. At least, with our strategy of having a first lien and tangible assets as collateral, recoveries are usually substantially higher than those of unsecured cash flow loans. We have learned that under the right circumstances, taking a more proactive approach can not only minimize the downside, but also produce a meaningful return, if you know what you are doing. It is not a path for all lenders, but over the past thirteen years, our lessons learned include:

- Sometimes, hard as it is, the best decision is to do nothing. Losses occur when making risky investments, but it is better not to compound the pain with more time and capital
- Management teams often prioritize revenue over profit in the believe that bigger is better
- Be proactive. Waiting too long can make matters worse, harder to fix and more expensive
- Avoid confrontation whenever possible and keep emotions in check. However tempting it is to fire off a confrontational e-mail, always consider how this will read in front of a judge
- Product and profit start with people
- Development of a common process and industry/professional contacts
- Critical first steps and the use of independent consultants to evaluate the situation
  - Re-evaluate the business plan
  - Do you have the right people to execute, even with a sound plan?
- Other popular misconceptions to consider:
  - Private credit professionals cannot run companies
  - Successfully transforming a small company can be done quickly
  - Losing key individuals means losing customers
  - Money can fix everything
  - Replacing the CEO/owner will cause irreparable harm

About Hunting Dog Capital

Hunting Dog Capital (www.hdcap.com) is a San Francisco-based investment manager that specializes in providing flexible financing, primarily in the form of senior-secured term loans, to lower middle market U.S. companies. Hunting Dog Capital's principals have worked together since 2002 and have extensive transaction experience that includes private debt, investment banking, corporate finance and restructurings. Investment opportunities are generated through a nationwide referral network that the Hunting Dog Capital team has developed and grown since 2004. Our lending criteria:

- Investment Size: $5 million+
- Term: 1 - 5 years, prepay without penalty after the first year
- Borrower Profile: Meaningful tangible assets
- Industry: Agnostic
- Geography: U.S.
- Use of Proceeds: Growth, Refinancing, Acquisition, Working Capital, Buyout
- Ownership: Concentrated with at-risk equity

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