A Quantifiable Impact

For direct-lending fund manager Steve Czech, ’98, success means making both profits and strides in medical research.

BY CHANA R. SCHOENBERGER
PHOTOGRAPHY BY STEPHANIE DIANI

Steve Czech, '98, is a quant. That's how he ended up in an underappreciated but lucrative corner of the alternative-investments market, lending money directly to companies who are no longer attractive to commercial banks (for regulatory or strategic reasons) and who don't want to issue equity or mezzanine debt.

Since inception, his Old Greenwich, Connecticut-based firm, Czech Asset Management, LP, has managed approximately $4.5 billion of committed capital, which it loans to medium-sized companies that generate annual revenue between $75 million and $500 million and annual EBITDA of $7.5 million to $50 million.

This business used to be the purview of commercial banks, which maintained long-term relationships with corporate executives. But industry consolidation and regulatory changes drove banks to push these loans off their balance sheets, creating an opportunity for Czech and a host of other Booth graduates who are his colleagues and competitors.

The companies that come to Czech for loans are making money but are too small for commercial banks in the wake of the industry's consolidation. Serving these borrowers requires Czech and his team to do the extensive diligence that commercial bankers once did, scrutinizing financial statements, touring factories and engaging with customers and suppliers.

For Czech, 55, nearly three decades in the corporate finance and lending business means he gets to help companies grow. At the same time, he's also working toward a different goal. All of Czech's funds, including his most recent $1.8 billion SJC Onshore Direct Lending Fund III, LP, bore his own initials, a common tactic among fund managers. But the initials aren't his alone; they stand for the first name of each member of his immediate family, including his wife, Jennifer; his daughter, Sydney, now 23; and his late son, James Michael, known as Mikey, who died in 2008 at age 11 from a rare, incurable form of childhood brain cancer.

The elder Czech closed the fund he was running on the day of Mikey's diagnosis—the boy found out he had terminal cancer on his 11th birthday—and spent the next nine months helping his son through treatment. It was Mikey who suggested that when his father eventually launched his next fund, he should name it after the family—"SJC."

Today the Czechs also run The Mikey Czech Foundation, which receives a percentage of the asset management firm's profits and funds research into the type of cancer that took Mikey's life, diffuse intrinsic pontine glioma (DIPG). Some 300 children aged five to 16 get this cancer each year, and there is no cure—yet.

Czech spoke with *Chicago Booth Magazine* about direct lending, the future of the economy, and cancer research funding.

ON SPOTTING THE OPPORTUNITY OTHERS MISSED

I was working for Donaldson, Lufkin & Jenrette (DLJ) in leveraged finance in 1998. Back then numerous commercial and investment banks were merging. One of the things that emerged from that consolidation was massive banks with massive balance sheets and massive commercial loan portfolios. Those portfolios had a significant amount of beta in terms of their returns—too much for most bank investors to stomach. These being public companies, the bank chief risk officers kept saying: "How do we minimize the volatility in these portfolios?" They wanted to underwrite and syndicate the largest, most liquid credits. They ultimately decided, "We're only going to underwrite and hold (or syndicate) loans to companies that generate a minimum of $50 million of EBITDA, and loans where we can underwrite $200 million or more, so we can syndicate them and sell them to secondary markets." Banks would keep the syndication fees and go on to the next deal.

So I'm working at DLJ, and on deal after deal, we end up passing because those deals don't meet the minimum $50 million EBITDA threshold. But these were very good companies, with great management, great products, great processes, and a reason to exist. Why are we turning these deals down? I concluded, "If I can figure out a way to start a fund to loan money to these middle-market companies, how great would that be? We can charge them more than they would pay to a commercial bank, but their cost of capital would be less than if they had to raise mezzanine debt or equity," which, at the time, were their only alternatives.

In 2003 I ultimately was able to make that happen. I moved to the buy side, to a firm that wanted to execute the direct-lending strategy. I built a fund from zero to several hundred million in assets under management. Then in 2008, my only son, on his 11th birthday—January 6, 2008—was diagnosed with terminal brain cancer. He died nine months later. I closed my fund the day he was diagnosed and stayed with him through his treatment process until the day he died.

Shortly after his funeral, a group at Morgan Stanley offered to seed my first stand-alone fund. In early 2010, I launched SJC Onshore Direct Lending Fund I, LP. We initially put $500 million on the cover when Morgan Stanley seeded us and we ended up raising approximately $1.1 billion in 10 months.

During 2010 Dodd-Frank was passed. Morgan Stanley was forced to dispose of most of its general partnership stakes. I was able to purchase Morgan Stanley's stake in 2011 and form my own stand-alone firm, Czech Asset Management, LP.

In 2012 we raised a second, $1.5 billion fund, and in 2016 we raised a third, $1.8 billion fund in about 100 days. It was spectacular! Most of the capital across all three funds was raised from our existing limited partners. We're direct, humble, and we don't show up on "Page Six" [the *New York Post*'s gossip column]. We've never lost sight of the fact that we are in business because of our investors, not despite them.

ON GAINING A BIG-PICTURE PERSPECTIVE

The vast majority of companies we lend to are manufacturing, transportation, distribution, and business services companies. In today's economy, many people wouldn't recognize those jobs. One of my favorite parts of the job is conducting the due diligence—engaging with management and walking the factory floor.

On the business front, now that tax reform has passed and the regulatory tidal wave is receding, our borrower's biggest concerns are: first, the impact of the 2018 tariffs on their businesses; and second, the ability to find employees with the requisite skills to fill open positions. How will it affect their revenues, expenses, and liquidity and their ability to expand? There's a growing sense of anxiety, and we're seeing it in the way companies are postponing expansion plans.

On the people side, a major concern for many companies is finding qualified employees. We talk to our portfolio company CEOs and CFOs every month and meet with them every quarter. For the last 18 months, they have found it increasingly difficult to fill job vacancies because they can't find people with the requisite skill sets to perform those jobs.

The biggest problem is finding qualified employees. That's a function of a record low unemployment rate and a very low workforce labor participation rate. Recent policy changes to welfare benefits, including healthcare, disability, food stamps, and housing assistance have begun to incentivize a lot of people to seek employment.

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Notwithstanding the aforementioned, another issue is the quality of primary and secondary education in the United States. When companies have to provide remedial reading, writing, and arithmetic education to new employees in their 20s, that says something about educational quality. I'm seeing this in companies that we've done business with. It's going to be something that will impair the ability of the United States to grow at its optimal rate.

Meanwhile, the economy has just boomed in terms of technology. Generally speaking, there are three stages of any market economy: agrarian, manufacturing, and high tech or a "knowledge economy." The US is clearly in the "knowledge economy" stage, yet we still have people being educated for agrarian and manufacturing jobs even though the numbers of those jobs are shrinking while "knowledge economy" jobs are increasing.

What a lot of these companies are trying to do is identify the jobs that involve repetitive processing, trying to find technology to replace those jobs, and then focusing efforts on jobs that require human judgement—not just artificial intelligence, where you can do something over and over again with machines or software.

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—Steve Czech

A new and growing issue compounding hiring difficulties has been the legalization of marijuana in many states for recreational purposes. Most business owners can't knowingly hire someone who can't pass a drug test. That's driven by their liability insurance, which is dictated by the insurance industry.

ON THE POWER OF THE BOOTH DEGREE

There are many Chicago Booth alumni in direct lending and private credit. I recently hired a new graduate who is fabulous. And **Howard Marks, '69,** who cofounded Oaktree Capital Management, has been doing this for over 30 years.

There are so many Booth graduates in this space because of the quant focus of the Booth MBA. I went to Booth in my late 20s. After six years working, I knew what I was good at and what I wanted to do—investment banking and corporate finance. Booth was the best place for that degree, and so it was the only school I applied to. Booth definitely got me into DLJ. Booth took a kid who was ambitious, with a lot of raw talent, and taught me how to think holistically.

The four best things I've done in my life are marrying my wife, Jennifer; having kids; graduating from Booth; and working at DLJ. At Booth, I acquired a firm grounding in core principles and a rigorous, multidiscipline approach to problem solving that has served me very well over the past 20 years since graduation and while traveling to over 50 countries. When Booth appears in your biography, it takes the conversation to another, higher level and has opened many doors.

ON THE OUTLOOK FOR MBA GRADUATES

There's clearly been a shift in MBA hiring. The private equity industry, banking, and the hedge fund industry were demonized in the last presidential administration. Some of that was deserved because of certain 2004-08 behavior. But when kids hear that every day for eight years, they're ultimately going to start believing it. People working on Wall Street and in the asset management industry do remarkable things for people every day. Regrettably, the mainstream media is not interested in those stories, only the outlier "bad-actor" stories.

You are likely to see more MBAs with world-class, quantitative skill sets steadily migrate to the multinational companies. Why? Because business is so competitive that, in order to succeed, everything needs to be measured. In order to measure something, you need to quantify it. In order to quantify it, you need to be able to count. Business schools steeped in quantitative curriculums will prevail. Business schools steeped in mastering PowerPoint and "Dress for Success" will not. You will likely see more MBAs migrate to private credit funds—we have the resumes to prove it. The credit markets worldwide are much bigger than the equity markets and private credit is becoming a huge part of the global credit markets.

ON SUPPORTING CANCER RESEARCH

You have a better chance of getting hit by lightning and eaten by a bear on the same day than you do of getting DIPG. The cancer incinerates a child's central nervous system but it doesn't destroy the child's mental faculties, so they know what's happening until they die. Doctors tell you there's nothing they can do: there's no remedy.

In the wake of our son's diagnosis, I said, "This is ridiculous." We identified the top researchers for DIPG, who are based at Dana-Farber [a Harvard-affiliated cancer institute in Boston]. Jennifer and I asked what it would take to stop the spread of this and cure it. They said it's going to take funding. DIPG doesn't move the needle for pharmaceutical companies, so we knew it would have to come from private philanthropy.

We said, "We're happy to do this and it will be a lifelong effort for us. We will not go away." Dana-Farber developed a clinical trial to identify the mutations that cause this particular cancer, reverse engineer them, and figure out how to prevent them from spreading. We funded a clinical trial that enabled researchers to develop a technique to do biopsies of DIPG tumors. They take the tissue to the Broad Institute at MIT and compare mutations to the catalog of cancer mutations at Broad. The thinking is: if the mutation in the DIPG tumor is identical to something that's been discovered, let's use a treatment off-the-shelf that's already out there and that's proven to be effective.

As a result of our philanthropy, they've been able to identify five mutations. Now they're in the process of developing chemical and biomedical treatments to create remedies to inject into the tumor to go after the mutations.

Every quarter we get a report from the researchers. If they meet certain milestones, they get another installment. The philosophy is: Show me results and you can have more money. Account for every dollar you spend. That's how we do it. Incentives matter. This is something that I learned at Booth. The late Booth professor and Nobel laureate Merton Miller used to say this all the time: Show me how someone is incentivized and I'll show you how they're going to behave.

We have donated over $2 million to DIPG research. It's not a lot of money in the grand scheme of cancer research. Most of the kids who die from this are very young and, consequently, so are their parents. As such, they lack the financial resources to do much about it. The only way you'll raise meaningful money is through people like us who have a platform and a vested interest.

When our son was diagnosed in 2008, no one knew if this disease would ever be conquered. Today, the researchers are talking about having a treatment in five to 10 years. A little bit of focus and a little bit of money—coupled with the advances in nanotechnology, biomedicine, and computing power—can result in amazing outcomes. As Jennifer and I are fond of saying, "What matters in life is not what you have. What matters in life is what you do with what you have." ✦