

SJC Fund Manager Fills a Void While Keeping Everything in Perspective

By Stuart P. Papavassiliou, March/April 2011

Deck: Shakespeare once asked, “What’s in a name?” For Steve Czech, founder and portfolio manager of FrontPoint Partners’ SJC Direct Lending Fund, it means a great deal. The \$1 billion-plus hedge fund provides privately negotiated senior loans to middle-market companies and is staffed by five experienced professionals. Moreover, it provides Czech with an opportunity to pursue a very personal, very important mission.

In February 2010, *ABF Journal* readers learned that FrontPoint Partners had hired veteran corporate finance executive Steve Czech to launch a direct lending initiative aimed at originating and investing in secured loans to the middle market. By the end of last year, the fund had raised a figure slightly north of \$1 billion, more than doubling its original target of \$500 million. For the fund’s founder, that’s just the beginning of the story...

For the Love of the Middle Market

Czech began his career in 1989 as a trainee at First Chicago Bank. “In those days, you were trained to do everything,” he recalls. “You did rotations in large corporate lending, middle-market lending, cash management, restructuring and trade finance. It was a great experience, and I got a great deal of training with respect to how banks work.” Three years later, he was recruited to join First Chicago’s competitor Continental Bank in that institution’s associate training program.

It was then that Czech was introduced to middle-market lending. He says, “I really fell in love with it for a couple of reasons. First, middle-market lenders, at least at that time, were the sole provider of capital to any particular company ... so they controlled the capital structure. Second, we had unfettered access to the owners and decision-makers of those borrowers as opposed to dealing with the assistant treasurer, who reported to the treasurer, who in turn reported to the CFO in some large corporate bureaucracy.”

The experience gained at Continental enabled Czech to perfect his expertise in the different pieces of the capital structure, not only in asset-based lending and cash-flow lending, but in debtor-in-possession financing, restructuring and highyield bridge loans. Czech explains, “I did all of that at Continental for about three years when I was recruited to ABN AMRO to be the chief credit officer for their middle-market lending group.”

From ABN AMRO, Czech went on to earn his M.B.A. from the University of Chicago and then to Donaldson Lufkin Jenrette’s (DLJ) leveraged finance group in Los Angeles. In time, Credit Suisse acquired DLJ, and Czech found himself running the mezzanine finance group at Credit Suisse’s New York office, a post he held from August 2000 to September 2003. It was at this point that Czech launched his first hedge fund with Contrarian Capital — a direct lending fund, which lasted until March 2008.

2008: A Year of Personal Loss, Economic Turmoil

In early January 2008, Czech’s only son, 11-year old James Michael, known by all as Mikey, was diagnosed with a diffuse intrinsic pontine glioma or DIPG, an extremely rare form of pediatric brain cancer. Understandably, Czech took leave of managing the Contrarian fund to take care of Mikey as the younger Czech

underwent treatment. Mikey lost his brave battle on September 7, 2008 — a short nine months after his initial diagnosis. Czech recalls, “There were more than 2,000 people at Mikey’s funeral including people from Goldman, JP Morgan and Morgan Stanley. And they said to me, ‘Steve, we understand that you are going to take time off, but don’t do anything until you talk to us. We want to do something with you ... some how, some way.’”

The conversations with JP Morgan, Morgan Stanley and other major financial players picked up in early 2009, during the days of TARP when the U.S. economy ground to a halt. While these players were in effect hamstrung as TARP recipients, Czech formed a joint venture with Gottex Fund Management. He explains, “I was ready to get back in the game and Gottex was my largest LP in my previous fund. We set up a joint venture, which we severed amicably when it became clear Morgan Stanley was best suited to raise money for us.” By mid-year, Morgan Stanley repaid its \$10 billion in TARP funds and not long thereafter, Czech joined FrontPoint, a Morgan Stanley company, structuring the fund, which would eventually come to be known as the SJC Direct Lending Fund.

SJC Direct Lending Fund — ‘What’s in a Name?’

And the name holds a great deal of significance for Czech. He remembers, “When it became clear that Mikey wasn’t going to make it, we talked about a lot of different things ... one of which was about the new fund I’d start some day. Mikey suggested ‘SJC Fund’, which I dismissed since those are my initials. I remember Mikey saying, ‘No Dad, you don’t get it ... it’s named for all of us.’” Mikey figured the “S” would stand for his father’s name as well as for his sister Sydney, while the “J” would stand for his mother’s name — Jennifer — and his given name James. The “C” would stand for the family name — Czech. “It was then Mikey told me, ‘That way, if something happens to me, you’ll remember all four of us.’ At that moment, Steve Czech concluded, ‘That’s the name.’”

As mentioned earlier, the original plan was to raise \$500 million in 12 months. Czech notes, “We had our first of four closings about ten weeks after the launch on March 31, 2010 and at that point we had already raised about \$335 million ... and that was just from a handful of institutions. We surpassed our initial goal by our second closing and we said, ‘There’s a lot more to be had here.’” With that, Czech and his team increased the fund size and tapped the Morgan Stanley/Smith Barney high-net worth distribution channel. “Once we received approval from that channel, we embarked on a ten-week road show. We told investors that we would cap the fund at \$1 billion, and we did, although we received commitments for about 40% more than that.”

SJC Direct Lending Fund is one of 15 or so hedge funds grouped under the FrontPoint name. While certain FrontPoint funds have received negative press lately, Czech assures, “As a FrontPoint fund, we each run our own businesses ... we make our own investment decisions, we hire our own people, we fire them when we need to and we have control over our own compensation in terms of the fees we receive from our investors. FrontPoint provides us with back-office services, including the legal, accounting, fundraising, compliance and risk management functions. So, it’s like running your own hedge fund business without having the worries of running the middle and back office.”

As for the fund itself, Czech describes it as an unlevered, unregulated, finite-life, self-liquidating commercial bank, filling the void left behind by the traditional sources of commercial lending restricted by regulatory or strategic reasons. He explains, “Much of what’s driving this need is the consolidation among the commercial banks. As banks get bigger, their loan portfolios get bigger and the amount of beta in the portfolio gets bigger ... the higher the beta in the portfolio, the higher the beta in the stock price. Hence, the only way to reduce that beta is to homogenize the risk in the portfolio by reducing the ‘box’ within which the

banks are willing to lend. The bigger these banks get, the smaller the box becomes in which they are willing to lend.”

On the demand side, Czech notes, “Borrowers still need innovative and flexible structures they can’t get from big banks anymore. We can do things from a structural perspective and from an interest rate perspective that banks can’t do because they are highly regulated and highly levered. We don’t use any leverage in our strategy.”

In terms of deal structures, SJC provides first and second lien term loans to borrowers with annual revenue ranging from \$75 million to \$500 million+ and annual EBITDA between \$7.5 million and \$50 million. As for a borrower’s profile, “We pretty much industry agnostic,” Czech says. But there are exceptions. “We won’t lend to any company in any way, shape or form that is involved in the auto industry or any of the so-called ‘sin industries’ ... those companies that are highly regulated with the potential to generate negative headline risk.” To the short list, Czech adds technology since that industry’s cash-flow characteristics don’t reconcile with the funds lower risk profile.

Who’s Who at SJC

Integral to SJC’s success is the experienced and talented team Czech assembled to run the fund. “Right now, there are five of us, and I’m proud to say that the average team experience is 23 years per team member. Everyone on the team has experience in every position necessary to have this business be successful. Everyone has experience deal sourcing, structuring, underwriting, monitoring and restructuring at major lending institutions and investment banks during their professional lives. What you don’t have here is people who are coming off bank debt or high-yield trading desks ... we’re all dyed-in-the-wool credit and corporate finance people.”

Joining Czech are Sze Ling Wan and Mark Newlun as assistant portfolio managers. Wan brings expertise in cash-flow structures while Newlun’s focus is on asset-based loan structures. Covering loan originations for the West Coast and Midwest are Tim Davitt and Chris O’Donnell, respectively. As for the eastern part of the country, Czech says, “Right now, that’s me ... ultimately we’ll build a team of ten to 12 people.”

Putting It All in Perspective

For Czech, his family’s loss was not only a pivotal point in each of their personal lives, but in his professional life as well. “Losing Mikey brought about the end to an old fund and it provided me the opportunity to launch SJC. But the most important thing for me is that a significant portion of what I earn from this fund and everything else going forward will go directly to the foundation that we set up in Mikey’s memory. There’s a bigger end to this for me ... it gives me the ability to fund the requisite pediatric brain cancer research required to find a cure for the cancer that killed him.” He concludes, “I’m on a very focused, very personal mission here.”

Editor’s Note: To find out more about The Mikey Czech Foundation and its work dedicated to pediatric brain tumor research, please visit www.MikeyCzech.org.
- Stuart P. Papavassiliou is senior editor of *ABF Journal*.