The Delchester Report – Views from the Junkyard

WHY DO I KEEP GETTING HIT BY A BUS??? The importance of building a durable succession plan and corporate culture during a time of great change in our industry.

When I started Penn Capital Management nearly 30 years ago, I wasn't thinking about succession planning. Since the beginning, my focus has been on building a sound business and delivering superior investment returns for our clients over a full market cycle. I spent my early years at Delaware Investment Advisors where I was a pioneer in high yield investing and managed one of the early high yield mutual funds – The Delchester Fund. In honor of that fund, which has changed names a few times over the years, I have aptly named my new periodic report – The Delchester Report.

This inaugural version will cover the timely topic of succession planning. Future versions will have a focus on special situation and distressed investing, which is why the appropriate tagline for this report is "Views from The Junkyard".

For 30 years, I have focused on building a business and mentoring a top-notch investment team. We expanded the business, introduced new investment solutions and most recently moved into new office space that allowed for a significant upgrade in technology infrastructure and overall workspace quality. The investment management industry is highly competitive and it is imperative to stay ahead of technological advancements and provide a quality environment to our most important asset – our employees.

My career began in the commercial credit department of a middle-market lender, Provident National Bank, which later merged with another bank and became PNC. This is where I developed my passion for digging through financial statements to determine how a company makes money to cover loan payments. Early in my career I realized that the capital structure of a company impacts investor returns. To be successful in this business, you must possess a tireless passion for understanding how the capital markets work and how it impacts the business cycle and thus, the companies in which we invest. So, you ask, "how does this relate to Succession Planning?".

In early 2016, we had a long-time client ask "Rich – what happens to the firm when you get hit by a bus?". Over the next 10 minutes I was run over by the proverbial bus numerous times by everyone in the meeting. We have always had a strong succession plan, but, in hindsight, we may not have always clearly communicated the plan. This question became the catalyst to reflect on and review the current plan, and ask one simple and direct question – "Is the plan in our clients' best interests?".

The conversation also led me to ask other members of our firm what they were hearing. They indicated our clients and their advisors routinely ask what happens when "the bus" hits Rich? So, in addition to our current plan, I now look both ways before crossing the street!

To be successful, firms must adapt to change; as we all know, the one constant we all face is change. As part of our process in reviewing and refining succession planning, Penn Capital's Executive Management Team extensively reviewed a recent McKinsey & Company report – *Thriving in the New Abnormal.*

It is not the strongest of the species that survives, nor the one most intelligent, but the one most responsive to change. - Charles Darwin

Our company is managed by an executive team comprised of the firm's senior members. We take great pride in running a well-managed business with the philosophy of maintaining substantial financial reserves, which has served the firm well. The importance of a strong balance sheet was one of the lessons I learned in my first job at a bank, and later when I ran my own bank, Covenant Bank, before selling it to First Union (which was later acquired by Wells Fargo). In 2008, when the investment management industry was facing extreme challenges, Penn Capital moved into new offices, took advantage of market dislocation, and hired additional staff.

When I left Delaware Investment Advisors to start Penn Capital, my wife Marcia and I put together a simple and straight forward business plan that serves as the foundation of our company today. The first decision – what do we call ourselves? We decided on Penn

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Capital in honor of William Penn, who clearly had a significant and lasting impact on our region of the country. Mr. Penn was also an entrepreneur, so Marcia and I thought the name appropriate since we were taking a very large entrepreneurial leap in leaving the apparent safety of Delaware Investments. (Ironically, about 100 other companies also liked the word "Penn" so it could not be trademarked which means that "Googling" us can sometimes be challenging!).

The next decision was the most critical – "What is our differentiated investment philosophy?". In the investment management business, alpha is dependent on capacity. This is especially true for credit and small cap investing – our two primary investment strategies. A hallmark of Penn Capital's investment philosophy is integrated capital structure analysis, which we refer to as "Complete Capital structure Analysis®". We hold such a strong belief in this philosophy that we trademarked this moniker. Understanding the complete capital structure of a company is, in my opinion, critical to delivering superior investment returns over a full market cycle. I am proud that over the past 30 years, I have recruited and assembled an investment team dedicated to this philosophy.

Another key decision was avoiding the pitfalls of this business, which can be distracting to a company's success. I drive a pick-up truck and my one indulgence is travel as I am an avid believer in the importance of understanding our global inter-connected economy. You can learn a lot from being on the ground and speaking with "the locals".

Two additional decisions Marcia and I made were arguably two of the most important. We did not want to build a "Family Business", instead, we were committed to building a "Business Family". We sought not a face-less business, but a company where collaboration and teamwork would be key attributes. I wanted to enjoy the people I worked with and it was important to me that we be accountable to each other. Was it always perfect and do we always get it right... of course not, but every company must learn and adapt.

Building "Business Family", means sharing the upside, hiring the right people, and building a partnership, which I refer to as "A Fraction of the Action". Employees who are owners will be more engaged and will embrace and help build a culture of philanthropy. More than 10 years ago, Marcia and I decided to commit our excess capital to building a Foundation in the name of my mother, who believed in the power of economic mobility through education. I mention this as a key decision since the Foundation is a crucial instrument in our client centric succession plan.

Finally, the last decision, and perhaps the most important as it pertains to succession planning – "What are we going to be when we grow up?". Every entrepreneur wants to be successful and build a promising legacy. I sold my bank, and kept my investment management firm, because my passion is investing and not banking. As a boutique investment management firm, there are various forms of succession planning. Most succession events involve a Mergers & Acquisitions (M&A) transaction. This brings me full circle to either selecting "the bus" or a M&A transaction.

Today there are profound macro trends having a substantial impact on the investment management business. Many of these were highlighted in the McKinsey report. The most impactful is the trend of asset flows into passive investing and associated vehicles like ETF's combined with institutional capital that can be allocated in record amounts into private equity and credit. These trends have put significant pressure on traditional active asset management firms focused on public securities.

As for Penn Capital, we believe our array of investment solutions are well positioned against these trends toward passive and private investing. Our high conviction approach, focused on inefficient segments of the market, can provide an appropriate balance between sufficient liquidity and alpha opportunities.

In regards to succession planning, we must ask if it is truly the right solution for our clients? Yes, I said it – as a fiduciary, we believe succession planning and corporate governance are critical to delivering superior investment returns. Clearly "getting hit by a bus" cannot be fully planned for other than through traditional estate

planning mechanisms, but we can build a client centric succession plan for the long term. To that point, we looked both within, and outside our industry, for viable solutions to answer the original question of this report – *"What happens when Rich gets hit by the bus?"*.

First, we looked outside the industry to noteworthy individuals like Bill and Melinda Gates and their estate plans, which are built around charitable giving. We studied the pledge made by Warren Buffett when his wife Susan passed away unexpectedly and he needed to re-think his estate plan. We then looked inside the asset management industry and reviewed the Stowers' estate planning and charitable work through American Century. Finally, we looked all the way to South Africa, where Allan Grey, founder of Orbis Funds Management, has put forth a succession plan focused on a fiduciary obligation to clients and the important alignment of firm equity ownership and investment performance.

As I previously mentioned, Marcia and I set up the company along with our Foundation, with a focused on helping disadvantaged children in the Philadelphia region, and beyond, through education. Over the past 10 plus years we have made a substantial gift of capital to support its mission. Currently we assist 90 children on an annual basis. Our goal is to grow the Foundation to positively impact the lives of 1,000 children on an annual basis. Penn Capital has been a conduit for Marcia and me to achieve our charitable goals and the firm's succession plan is aligned with these goals. As we move forward, we are augmenting a process of equity transference to investment team members who deliver superior returns for our clients. We fully understand that if we succeed in delivering on our fiduciary promise, our firm will grow, which, in turn, will allow us to meet our goal of improving the lives of 1,000 children.

Much has been written recently about the limited number of women, and particularly minority women, in investment management roles in our industry. Since I have been fortunate to have worked with both my daughters, and Marcia, at Penn Capital during various stages in the firm's history, supporting the advancement of women in the investment industry is an important priority and personal mission. We will be supporting various organizations and programs focused on improving employment opportunities for women in investing. Our first step will be a program that supports a Philadelphia high school with a program focused on girls and investing.

For Penn Capital to successfully execute on these initiatives, we cannot be distracted with trying to determine which M&A transaction or private equity investor is best for the firm since none of these endeavors will add one basis point of alpha to our client's portfolios. We must be focused on the long term since our investment philosophy of high conviction investing is based on investing over a full market cycle. Our clients need to know that we have a plan, and that we will vastly improve upon this plan over the next decade.

Our client centric succession planning involves the gifting of the Hocker interest to the Foundation. Like Mr. Grey and Mr. Stowers, we believe a charitable owner is the best long term fiduciary solution on behalf of our clients' long term interests. More importantly, our current and future employees will be fully engaged and secure in the knowledge that ownership in the company is not only aligned with our client's best interests, but with their best interests as well.

This plan ensures when that darn "bus" comes along and finally takes me with it, the clients and employees of Penn Capital will feel secure in knowing the firm is in good hands. As previously mentioned, if we continue to outperform, a portion of our personal earnings will go toward improving the economic mobility of children through education, which Bill and Melinda Gates believe is of national economic importance… as do I! Additionally, the employees of Penn Capital are committed to building and supporting the next generation of women and minority investment management professionals. These are big plans, and there are many details to follow in an upcoming whitepaper on Succession Planning.

While I can't predict Penn Capital will be the next Wellington Management or Dodge & Cox; two examples of successful investment focused partnerships, I can promise our clients that revenue earned by Penn Capital will be used to

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improve the lives of our Foundation's beneficiaries, support our firm-wide charitable endeavors, and hire, retain and support a great team of investment professionals dedicated to delivering superior returns.

The institutional boutique investment management firm model has faced many obstacles over the years. Some firms have grown through those business risks, some have been gobbled up, and others faded away. We are confident that by implementing a succession plan built on a fiduciary foundation of client centric principles with a strong charitable vision, managed and supported by mission driven employees, Penn Capital will be around for the next CEO to worry about "getting hit by the bus".

It is an honor and privilege to be entrusted with our clients' assets. We understand that active management is a difficult task, which has only become more challenging over the past five years, but we are committed to living up to our fiduciary promise to our clients.

Markets can be cyclical and our areas of investment focus can sometimes be a bit volatile. For those investors and fiduciaries who may have invested with Penn Capital in the past, we invite you to see the changes we are making to improve our ability to outperform.

During this, our 30th anniversary year, I will be reaching out to our clients, and their fiduciaries, to discuss our succession plan and the capital reinvestment we are making in our firm. Until then I thank you for taking time to read this inaugural issue of ***The Delchester Report – Views from the Junkyard.***

Sincerely,

Richard A. Hocker, Founder
Chief Executive Office and Chief Investment Officer

Specialists in capital structure investing

At Penn Capital, we believe that understanding a company's entire capital structure is the best way to identify investment opportunities with the most value. In fact, we've found that managing bond portfolios makes us better equity managers, and vice versa.

Our fully integrated credit and equity research process focuses on non-investment grade companies in the micro to mid-capitalization range, where we can take advantage of inefficient security pricing.

We are an independent, employee-owned boutique investment management firm based in Philadelphia. We forge our own ideas, we respect hard work, and we are committed to our clients, our staff and our community.

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