# Case Study

## Huntington Capital Fund II, L.P.

**November 2013**

<table>
<thead>
<tr>
<th><strong>Organization Headquarters</strong></th>
<th>San Diego, California, U.S.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fund Vintage Year</strong></td>
<td>2008</td>
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</table>
| **Leadership**               | Morgan Miller, Managing Partner  
                              | Tim Bubnack, Managing Partner |
| **Description of Primary Asset Class** | Growth capital structured as mezzanine debt and/or preferred equity |
| **Fund Size**                | $78 million                 |
| **Geographic Focus**         | Southwestern and Western U.S.: California, Arizona, Nevada, Oregon and Washington |
| **Sector Focus**             | Companies with $10 million to $75 million in revenue, in the manufacturing, healthcare, services, and IT sectors |
| **Summary of Impact Areas**  | Access to finance for small- to mid-sized businesses; creating quality jobs in underserved areas with a focus on living wages and health/retirement benefits; workforce diversity |
| **Financial Performance**    | 13.78% net IRR at March 31, 2013 |
| **Social Performance**       | 352 total jobs created; of the 2,811 total portfolio company employees at December 31, 2012, 78% reside in low- to moderate- income areas; nine of 16 portfolio companies (56%) are owned or operated by an ethnic minority individual or female |

Ben Thornley and Brenna McCallick were the lead authors of this case. This case study is part of The Impact Investor, a research partnership between InSight at Pacific Community Ventures, CASE at Duke University and ImpactAssets from 2012-2013. The Impact Investor project team was co-led by Cathy Clark, Jed Emerson and Ben Thornley. More in-depth impact investing fund case studies, practitioner blogs, videos from expert convenings, as well as project reports, are available at: [http://bit.ly/impinv](http://bit.ly/impinv) and at the twitter hashtag #impinv2.

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INTRODUCTION

In 2007, Morgan Miller, Co-Founder and Managing Partner at Huntington Capital, traveled from the firm’s headquarters in San Diego, California, to the Bank of America Merrill Lynch “BAML” Capital Access Funds Annual Conference in New York City. Capital Access Funds provides a specialized service to large pension funds, endowments and other institutional investors with discrete investment programs intended to support economic development in targeted U.S. geographies and populations.

As Morgan listened to BAML explain its objectives – access to finance for underserved small- and medium-sized businesses, job creation in low-income communities with health and retirement benefits, increasing workforce diversity and supporting businesses owned by women and ethnic minorities – he came to the realization: “that’s exactly what we do at Huntington!”

With a background as a bank credit officer in emerging markets and an advanced degree in economics focusing on developing economies, Morgan and his founding partners had intuitively created Huntington Capital to serve lower middle-market companies in a range of non-high-technology industries (primarily manufacturing, consumer and business services, aerospace, and healthcare). With a focus on the racially diverse southwest area of the U.S., Huntington’s investments were creating the exact social impacts BAML Capital Access Funds was seeking.

Coinciding with Huntington’s efforts to launch a second fund, Huntington Capital Fund II, LP (HC II), the BAML conference was a revelation. Morgan and his partners realized there was demand for Huntington’s services, driven in part by government regulations, political imperatives, and philanthropic missions that encourage institutions to invest in a targeted fashion without sacrificing financial returns. The firm’s value-add – strengthening top management and governance systems at portfolio companies, helping with capital raises, and facilitating mainstream banking and other business relationships – had proven to be impactful, delivering a net IRR of 9.5 percent in Huntington Fund I through June 2013, despite tough market conditions.

In response to the BAML conference, the launch of HC II became an opportunity to articulate the firm’s mission and engage with institutional investors interested in achieving social objectives along with market-rate returns. In the process, Huntington began to memorialize impact goals in its Limited Partner (LP) Agreement.

HC II would be a balancing act, explicitly promising to deliver the social impacts that had been an inherent outcome of Huntington’s investment strategy for some years and ensuring that this social value would continue to complement and support the delivery of financial value. While the balance was not achieved on every deal, in the aggregate, the fund has reported exceptional financial and social performance.

By March 31, 2013, HC II reported a net IRR of 13.78 percent and a cash multiple of 1.37x, placing it within the upper quartile of 2008 vintage year mezzanine funds.\(^1\) On the social side, HC II portfolio companies employed 2,811 “Full-Time Equivalents” (FTEs) at December 2012, up from 2,459 at the time of HC II investment. Of these employees, 2,210 (78 percent) were

\(^1\) According to March 31, 2013 Benchmark data from Cambridge Associates LLC U.S. Private Equity Index® and Benchmark Statistics Report
residents of low-income communities, 1,787 (63 percent) were classified as ethnic minorities and 1,155 (43 percent) were female. Nine out of 16 portfolio companies (56 percent) were owned or operated by an ethnic minority individual or female. HC II is testament to the potential for mezzanine debt funds to deliver solid employment growth through enterprise expansion, distinct from the explosive growth of venture capital, and exceptional social targeting.

This case describes the creation and deployment of HC II as an impact investing fund and the three elements that have enabled Huntington Capital’s binding commitment to delivering social impact and achieving market-rate financial returns: the character of the firm, its particular investment strategy, and clear accountabilities.

**ORIGINS**

Huntington Capital was founded in January 2001 by namesake Richard (Dick) Huntington, Barry Wilson, and Morgan Miller as a private equity firm focused on lower middle-market companies. Dick was a respected business leader in Southern California and the founder of University Mechanical, an engineering firm that he grew from the back of his truck to over $150 million in annual revenue. Barry was a venture capitalist with 17 years of experience, including several years with the Michigan Department of Treasury’s Venture Capital Investment Division. Morgan had been a senior lending and marketing officer responsible for Bank of America’s lending in Puerto Rico and the Caribbean, and was subsequently responsible for all banking activities in the San Diego area for one of the nation’s top community banks, Rancho Santa Fe National Bank.

Tim Bubnack joined the team as a managing partner in 2007, leaving his position as head of the San Diego region for Silicon Valley Bank. Tim brought over a decade of experience in banking. His expertise included developing and managing early-stage and middle-market relationships, identifying direct equity opportunities and venture fund investments, and structuring creative enterprise loans, including several with Huntington. Tim also had strong business development credentials.

Huntington’s first fund was a Small Business Investment Company (SBIC), registered with the Small Business Administration (SBA), a government agency that provides advocacy and capital to small businesses in the U.S. The fund consisted of $7 million in LP commitments and up to $21 million in SBA leverage.

The SBIC program has been in operation since 1958 and provides publicly-guaranteed leverage to privately-owned and managed investment funds for the purpose of capitalizing small businesses, which are defined broadly by the SBA as having up to 500 employees or $21.5 million in revenue, depending on industry sector. By 2012, the program included more than 300 SBA-licensed funds with over $18 billion in capital – $9.4 billion from private investors and $8.8 billion from SBA leverage commitments.

According to Miller, the firm’s social impact goal “wasn’t an accident, but it wasn’t all that intentional either.” He explains, “We were trying to create a fund that would make money and be a success for investors. My partner, Barry, had started a venture fund in Michigan, primarily to create jobs. I was coming from commercial banking including 10 years in Latin America. Economic development was a big part of the work. Studying the impact of investment in emerging markets and identifying ways we could stimulate growth drove us.”
HC I invested approximately $36 million in 25 companies and was recognized by the SBA as one of the fastest SBICs to reach profitability, in its fifth quarter of operations. After making it through the Great Recession (2008 to 2012), HC I reported a net IRR of 9.5 percent and a cash multiple of 1.16x through the life of the fund, as of June 30, 2013. Huntington attributes this solid performance to its innovative royalty financing model for SBICs and mezzanine funds focused on small and medium-sized enterprises (SMEs); a strategy also deployed in HC II.

**FUNDRAISING: LEVERAGING A POLICY TRIGGER AND CORNERSTONE SUPPORT**

While raising the second fund, the partners contemplated going the SBIC route again. They completed the application and initial vetting process, and received approval to move forward. However, by 2007 the SBIC program was out of favor with investors, prompting the firm to opt out of registering with the SBA. According to Huntington, multiple large institutional LPs were not supportive of the SBIC option and had determined that the overall expense structure related to the SBA leverage and effective management fees were too costly. In addition, some LPs did not want to have “government in front of them” when it came to distributions.

Nevertheless, the role of public policy in HC II’s creation remained significant. Among the larger investors in HC II were the California Public Employees Retirement System (represented by Hamilton Lane and Credit Suisse), the California State Teachers’ Retirement System (represented by Invesco), Northwestern Mutual (represented by Macquarie), Allstate, Farmers, Pacific Life, State Farm, Safeco (represented by Impact Community Capital), Union Bank of California, and the FB Heron Foundation. Commercial banks were attracted to HC II because their investment in the fund, with its anticipated social impacts, qualified for credit under the Community Reinvestment Act (CRA), a U.S. regulation that requires depository banks to make loans and investments in underserved communities where they have branches. For insurers, HC II met the requirements of the California Organized Investment Network (COIN), a California Department of Insurance program modeled after the CRA which requires insurers to invest in underserved communities on a voluntary but closely monitored basis.

HC II’s fundraising efforts lasted approximately two years. The fund’s first close was at $52 million in May 2008; the final close at just over $78 million was in October 2008.

Bubnack decided to join Huntington fulltime in June 2007 when it seemed likely that Citibank would be the fund’s lead investor. According to Bubnack, there were two other notable fundraising developments at that time. First, Bank of America Capital Access Funds was willing to make introductions on Huntington’s behalf. Second, HC II was recognized in California as “COIN qualified” by the California Department of Insurance. HC II’s COIN status prompted Impact Community Capital to invest on behalf of its numerous insurance clients, and helped pave the way for other providers of targeted institutional capital, including Hamilton Lane and Invesco on behalf of the California pension funds. It helped that the basic employment data and demographic information that Huntington had been tracking for the SBA, including portfolio company job creation metrics, portfolio company head office/facility location, and portfolio company compliance with SBA small business guidelines, were strong compared to other impact funds.

While arduous, the fundraising process for HC II was also a period of discovery. Miller’s experience at the BAML conference in New York, coupled with feedback from prospective LPs, led to the emergence of a more holistic understanding of an investment strategy that would produce both financial and social value, and provide clarity on Huntington’s role in impact investing.
CHARACTER: THE MARK OF AUTHENTICITY AND MISSION ALIGNMENT

The word that best describes the character of Huntington Capital is “authentic”: Huntington’s founders Morgan, Dick and Barry shared a deep love for and understanding of how to grow underserved small businesses. Morgan’s banking and business experience contributed skills in lending, restructuring troubled loans, strategic planning, and providing financial management for SMEs. Barry brought years working in venture capital and tenure as founder and CEO of Capital BIDCO, a Michigan-based Business and Industrial Development Corporation that pioneered the structuring of royalty-based financing for small businesses. Dick had been making loans to fellow entrepreneurs and was excited to formalize these investments and deploy capital into underserved opportunities, while making a good return on his investments.

In practice, these experiences have driven Huntington’s primary value-adds: strengthening top management and governance systems at portfolio companies, helping with capital raises, and facilitating mainstream banking and other business relationships. Huntington has also been commended for its concrete commitment to tracking and reporting impact in a way that some LPs say is the best they have seen.

To be sure, Huntington Capital’s character has been a big draw for LPs. One of these investors, Kate Starr, Vice President, Capital Deployment at F.B. Heron Foundation, was quick to emphasize character when reflecting on that institution’s $2 million mission-related investment in HC II seeking concurrent market-rate financial returns and social impacts:

“Character makes a huge difference – not only in ensuring good LP/GP [General Partner] relations, but in the relationship between GPs and their portfolio companies. You have to know that the symbiosis goes all the way through and that the GP will take seriously the role of social impacts in working with management. If social impact is part of the ethos, GPs and management will think about the consequences of any financial event on the enterprise and its workers. We only want to take the risk of investing in private partnerships so that GPs can create real long-term value.”

THE FUND

Consistent with the objective of the LPs, comprised primarily of investment fiduciaries, HC II was created first and foremost with a financial mission: to be a best-in-class debt and equity fund focused on underserved lower middle market companies in California and the Southwestern U.S. As a secondary goal, HC II was expected to invest in companies that have a “positive impact on their communities, particularly with the potential for job growth.”

In other words, the social impact of HC II was expected to result naturally from investments in small- to medium-sized companies underserved by traditional capital providers. This segment of the market was attractive to Huntington (and to Huntington’s investors) primarily because it offered a financial opportunity. Asked to describe the Golden State Investment Fund (GSIF) investment in HC II, Hamilton Lane Vice President Miguel Luiña emphasized the business case that had impressed all of the LPs: “Huntington Capital’s strategy of providing non-control mezzanine debt to smaller companies often overlooked by the banking sector plays a complementary role in many private equity LP’s portfolios. Huntington has been a reliable partner for us and we’re pleased with how they’ve executed.”

According to Huntington, there exists a gap in the capital markets between venture capitalists focused on a finite group of technology-centered businesses and conventional commercial bank lenders or larger private equity funds. This leaves a significant number of undercapitalized growing businesses trying to introduce new products, acquire competitors, upgrade equipment,
move to new facilities, or begin an exporting program without a source of growth capital. HC II focused on companies with $10 million to $75 million in revenue, in the manufacturing, healthcare, service, and IT sectors. According to Huntington, there are only approximately five other active funds that target a similar market and are willing to deploy less than $10 million per transaction in the same region of the U.S., reflecting the underserved nature of the lower middle market by institutional capital.

**GOVERNANCE, FEES AND STRATEGY: A CONTINUUM OF IMPACT**

HC II’s governance arrangements are not dissimilar to those of most other private equity funds. The fund includes an investment committee, comprised of Morgan Miller, Tim Bubnack, and new partner Frank Mora, with ultimate fiduciary responsibility for all capital deployments. It also created an advisory committee consisting of LP representatives from Hamilton Lane, Invesco, Credit Suisse, Impact Community Capital, and Macquarie Funds Management, which has been an active and “very supportive” committee according to Bubnack.

The Fund’s fee structure is consistent with industry norms, including a two percent management fee and a 20 percent performance-related carry on interests exceeding an IRR of eight percent for LPs.

In order to serve their target market, HC II has utilized a range of financial instruments, including:

- **MEZZANINE LOANS.** These loans have a five-year term with full or partial amortization. Interest rates range from 12 to 14 percent, with prepayment fees. The loans are typically subordinated to senior lenders and Huntington requires a secondary lien on assets, or stock pledges.

- **EQUITY.** 43 percent of HC II’s deals included an equity component, totaling 18 percent of all invested capital.

- **WARRANTS.** 86 percent of HC II’s deals included warrants that entitle the fund to participate in the equity upside of a deal and enhance its overall yield.

- **ROYALTY-BASED FINANCING.** 29 percent of HC II’s deals included a royalty feature, where business owners agree to pay a percentage of the increase in gross company receipts, designed primarily to alleviate the need for a single event exit strategy. Huntington pioneered the use of the royalty-based financing model in the mezzanine/SBIC space.

It is useful to think of Huntington’s investment strategy – and the drivers of its financial and social performance – as falling on a continuum.

At one end are the largest and most established companies, often referred to Huntington by another private equity fund or investment banker. HC II may be among a number of firms competing for a deal, and the financing ultimately looks like a traditional mezzanine loan with no royalty-based financing, and no board seat (but always an observer position).

In working with these larger companies, the financial return to HC II primarily includes the coupon interest rate on debentures, in some cases a warrant gain or performance fee, return of principal, underwriting, and origination fees. Because of Huntington’s lack of control over these companies and the availability of other sources of capital, social performance results largely from the company’s anticipated residual impacts – through its location, employment practices, products or services. Simply put, Huntington creates social impact in this scenario primarily as an aggregator of mission-aligned businesses, at the fund level.
At the other end of the continuum are smaller companies, where Huntington identifies deals through its proprietary networks, and is often the only provider of capital. The financing looks more like a structured loan investment, with some control through board participation and an active role helping management create additional value. Control levers are enhanced through the security and loan agreement to protect Huntington in case the investment turns sour.

For these smaller companies, the financial return to HC II comes from income associated with the loan, as well as significant equity appreciation and royalties. Social performance results not just from the residual characteristics of the company, but also from Huntington’s more essential role in sustaining or accelerating impact using capital that might not otherwise have been available. Here, HC acts as an advisor and hands-on investor/owner, including through board participation.

According to Hope Mago, an investment professional at Huntington Capital, HC II tends to be more deeply engaged with portfolio companies with less than $25 million in revenue. These companies typically have a founder wearing many hats, with less depth on the bench, and require improved governance structures and assistance in developing budgets and strategic plans. Huntington helps create value by focusing closely on enhancing the quality of management, participating on the board, and monitoring performance in close concert with company CFOs.

**MANAGEMENT STYLE AND PHILOSOPHY: A FOCUS ON RELATIONSHIPS**

Huntington’s management team claims its primary strengths are flexibility and creativity in structuring deals; financial management and industry expertise; and a reputation as a supportive lender that places a high value on integrity. “Our philosophy is that in order to be socially responsible in business, we need to create successful, profitable businesses,” says Miller. “Even if a deal represents an impactful social investment, if it doesn’t meet our financial and investment criteria, we won’t do it. We may be unusual in that we’re entrepreneur and success focused, but we are also consciously aware of social impact and governance.”

Huntington’s philosophy all adds up to a resolute focus on investee relationships. The team’s extensive experience in the SME market enables Huntington to offer expert advice to its growing portfolio companies. HC II’s openness to creative deal structuring attracts companies that might otherwise turn to traditional bank loans, which typically do not provide sufficient capital or guidance for growth and job creation. The firm’s core values and character ensure that, when Huntington redoubles efforts to support an underperforming loan, it is not just out of financial interest, but because of a genuine concern for the wellbeing of a company’s employees.

This does not mean that Huntington “bleeds impact,” Bubnack reiterates, although the firm screens very intentionally for companies whose management demonstrates the same integrity and judiciousness on which Huntington prides itself. Huntington understands it can offer the greatest benefit to companies that share its values and commitment to the type of sustainable growth that adds resilience to their workforce.

“We are backed by people who want measurable impact. It’s part of our culture and value system and starts with our initial deal screen,” says Bubnack. “It’s not number one on our deal screen list, but it’s an essential component of the process. Numbers one to eight are performance, management, and other elements to ensure a good financial return. But numbers nine and ten relate to how this is going to be a socially responsible investment. It is a conscious decision and implementation and execution of this strategy is an attitude. This is our target market and the mission of our firm.”
Miller adds, “When we meet a company, we explain our social mission. Owners pride themselves on being a preferred employer in their local labor market. We are a partner who goes to extra lengths before reducing headcount. It’s not that we don’t have to cut staff sometimes to improve lagging performance, but that we understand that jobs represent people, often with families. This approach plays a role in building trust with employees and management.”

Entrepreneur Robert Melsness, owner of Advanced Structural Alloys (ASA), a Huntington portfolio company, can speak to the singularity of the firm’s values as an investor. When Melsness’s company took a hit during the financial crisis of 2009, Huntington organized a restructure plan to save it. The move “preserved core jobs in the community here,” Melsness says. “We are in a redevelopment zone, and jobs in this area are very important.”

MEASURING AND REPORTING PERFORMANCE: ACCOUNTABILITY THROUGH LP ENGAGEMENT

More than just deploying capital, a number of anchor investors worked directly with Huntington to clarify what it would mean to participate in impact investing through HC II and how, precisely, a strong system of accountability would produce robust social performance. A key feature was Huntington’s tracking and reporting systems, which serve to solidify the fund’s non-financial objectives.

These efforts addressed the needs of Huntington’s bank and insurance company investors, described above. Another particularly important stakeholder was the Golden State Investment Fund (GSIF), a $550 million investment managed on behalf of the $240 billion pension fund CalPERS by Hamilton Lane, a large private equity fund-of-fund headquartered in Philadelphia. GSIF was designed explicitly by CalPERS to generate an attractive financial return while investing in areas of California underserved by conventional private equity capital, providing jobs to residents of low-income communities, and supporting women and ethnic minority business owners and managers.

The process of figuring out how social performance would be tracked was also motivated by the fact HC II was not an SBIC. As an SBIC, HC I automatically qualified bank LPs to receive “CRA credit” under the law, contingent on intermediaries like Huntington submitting a report to the SBA each year detailing the scope and impact of their investments. Without the SBIC certification, however, HC II would need to provide additional evidence of impact.

“As an SBIC, you automatically qualify for CRA purposes,” Miller explains. “We didn’t really need to track [social impact] carefully, but we did track it somewhat. The second fund was not an SBIC, so we needed to go by different criteria.” Huntington worked closely with their LPs to design a tracking system for HC II. “The question was, what is the threshold we need to meet to convince regulators we really are a socially responsible fund?” says Miller. “Through conversations with LPs we settled at 60 percent [of capital deployed for impact].”

Huntington explicitly stated that 60 percent of the Fund’s investment activity would be targeted toward impact investments, defined as qualifying investments in underserved businesses. Huntington defined underserved businesses as those that were: (i) underserved by traditional capital sources, defined as banks, venture capitalists, or institutional investors; (ii) located in low-and-moderate-income (LMI) areas and employing individuals residing in LMI areas, and/or; (iii) that employed or were operated or owned by ethnic minorities and women.

More specifically, Huntington evaluated each potential deal on the basis of the following characteristics: facilities located in an LMI area; businesses operated/owned by an ethnic
minority/female; percentage of employees residing in LMI areas; employees earning LMI wages; percentage of ethnic minority/female employees; and whether the company met SBA small business guidelines, defined broadly as having up to 500 employees or $21.5 million in revenue, depending on industry sector.

Mago notes that the evaluation process has been somewhat subjective, as it “blends all of those metrics.” In HC II Huntington labeled companies as “impact investments” if they met at least 50 percent of the criteria. While over 80 percent of invested capital has exceeded HC II’s impact goals, Mago says the process was continually evolving as capital was deployed. “Now we have a set process for evaluating impact criteria upfront,” he adds.

Huntington reports social performance annually to its LPs, and financial performance quarterly. Huntington provided side letters to six of its 15 LPs, confirming that their non-financial interests would be pursued explicitly in the course of making investments, and that performance against these objectives would be fully documented. These clear elements of accountability for social performance, as well as the mechanics of HC II’s investment strategy, have been essential to Huntington’s LPs.

INVESTMENTS

HC II made its first investment in August 2008 and has invested in 22 deals as of March 31, 2013. For these deals, HC II committed $69.3 million, of which $55.8 million was debt investment and $13.5 million was equity investment. The average deal size across the portfolio is $3.2 million.

The 22 deals emerged from a pipeline of 590 companies, including 119 that made a “watch list” and 31 to which Huntington submitted a term sheet but did not close, usually because a larger borrower opted to look elsewhere for financing, or because the 60 days of diligence from term sheet to credit memo revealed additional information on a risk profile that caused Huntington to decline to invest.

Of the 22 deals in HC II, 33 percent were referred by portfolio companies and management teams that had worked with Huntington previously, 29 percent were referred by other GPs with which the firm has relationships, 14 percent were co-investments with other private equity funds and boutique firms, 14 percent were presented to Huntington by an investment banker or financial broker, five percent were referrals from banks, and the remaining five percent were referrals from LPs. This broad pipeline illustrates the importance of the financial ecosystem and networks in which impact investing occurs.

Over 70 percent of HC II’s investments have been made to support growth initiatives such as geographic expansion, acquisition strategies, and product development. The remainder of the investments has primarily supported buyouts and refinancing. The remainder of the investments has primarily supported buyouts and refinancing. Figure 1 below details each of Huntington’s HC II investments from fund launch through the end of 2012.


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<th>COMPANY</th>
<th>INDUSTRY</th>
<th>INVESTMENT DATE</th>
<th>TOTAL CAPITAL INVESTED ($ MILLION)</th>
<th>STRUCTURE</th>
<th>BOARD/OBSERVER SEAT</th>
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<td>Mezzanine Debt</td>
<td>O</td>
<td>No</td>
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<tr>
<td>Vantage Mobility International</td>
<td>Manufacturing</td>
<td>1/6/2011</td>
<td>2-5</td>
<td>Mezzanine Debt</td>
<td>O</td>
<td>No</td>
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<tr>
<td>Vertical Management Systems</td>
<td>IT-Software</td>
<td>6/2/2011</td>
<td>2-5</td>
<td>Mezzanine Debt/Equity</td>
<td>B</td>
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<td>Wave Technology Solutions</td>
<td>IT-Software</td>
<td>12/24/2010</td>
<td>2-5</td>
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<tr>
<td><strong>Total Current &amp; Partially Exited Investments</strong></td>
<td></td>
<td></td>
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<td></td>
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<td>$0</td>
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<tr>
<td><strong>Total Exited and Current Investments</strong></td>
<td></td>
<td></td>
<td>$69,346,593</td>
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**Investment Profile: Vantage Mobility**

Based out of Phoenix, Arizona, Vantage Mobility International, LLC (VMI) converts vehicles for use by disabled persons, and manufactures wheelchair lifts and other accessibility products. The company was founded in 1987 and holds the second largest market share of the personal mobility sector in North America. In 2010, with consolidated assets totaling $38 million, the company approached several investment firms for funding to support their general working capital requirements, including a planned Honda/Chrysler platform change.

Huntington was introduced to the company by Pine Creek Capital, another mezzanine fund, and quickly recognized there was clear alignment of values. In addition to providing practical solutions to a widespread social need, VMI employs workers from LMI communities or ethnic minority groups. In fact the majority of its 165 employees fell into these categories.
VMI’s CFO, Tim Barone, had asked to see some alternatives to mezzanine debt with a warrant structure from Huntington, to which Huntington responded with four prospective loan options, each with different equity or cash flow enhancement structures.

HC II was competing with four other investment firms for the business. While their offer was not the least expensive, it was ultimately accepted because it provided the flexibility VMI was looking for. The final agreement consisted of a $3 million mezzanine debt investment over five years at 13 percent interest, granting HC II a second-priority lien. The deal was not dependent on an accelerated-growth scenario or traditional exit event, but was structured instead to be higher yielding through the use of a three percent “payment in kind” and a guaranteed exit fee ranging from $250,000 in year one to $500,000 in year five. HC II received no warrant or equity interest as part of the funding.

In the VMI deal, as in others, it was important that Huntington distinguished itself from the competition. Miller notes, “We are more than just a lender, with cold, hard cash coming in. VMI knows we care about the company. We flew out for the opening of their retail store. We’ve been very supportive. We love what they’re doing.”

Barone comments, “For the last two-and-a-half years, Huntington Capital has been an outstanding partner for VMI. They have been instrumental in our growth, both from a revenue and EBITDA performance perspective. Morgan Miller and his team have been there for us at every turn with both capital as well as business acumen support. The best thing that I can say about Huntington is that, when the need arises for more capital, they will be the first phone call that I make, and that I have recommended their firm to many people in the financial community.”

Bubnack adds, “It comes down to our team, who we are. People can rapidly figure out what our value system is. We want to work with people who have the same principles as we do.”

In finding these types of deals, Bubnack explains that he looks for the kind of people he would bring onto the Huntington team. “We don’t have big attitudes here,” he explains. “We’re just trying to build something successful, and our reputation is extremely important.”

At March 31, 2013, total realized and unrealized proceeds from HC II’s investment in Vantage were valued at $4.3 million, representing a 24.3 percent IRR and a 1.43x cash multiple.

**Investment Profile: Diamond Contract Services**

Diamond Contract Services (DCS) is a full-service janitorial company that specializes in educational institutions and government facilities. DCS was created in 1993 and is based in Southern California. The firm came to Huntington’s attention in 2009 through a referral from an HC II LP. With revenue of $26.6 million, a growth rate of 24 percent annually, excellent contract renewal rates, and an ethnic minority owner, DCS represented an attractive financial and social proposition.

HC II provided DCS with a $2 million mezzanine/subordinated loan in May 2009, including a warrant for 3.5 percent of ownership, and a royalty stream comprising 0.75 percent of all sales above $6.7 million during the five-year term of the financing.

Unfortunately DCS’s financial situation began to deteriorate soon after HC II made the investment. Huntington’s initial funding was used primarily to provide additional working capital to the company’s weakened balance sheet stemming from a significant loss with SunTrust Bank, at the time the company’s largest account in the South East region (since terminated). Diamond won a bid to clean 1,100 SunTrust facilities beginning in 2008 and, after hiring a majority of the existing employees from the prior vendor, discovered that a high percentage were undocumented workers who had to be let go.
Diamond incurred the incremental costs of rehiring employees, paying overtime to the remaining employees covering the shifts of laid-off workers, and training new employees, leading to over $1 million in unanticipated expenses. As a result of the company’s already tight liquidity position prior to this incident, HC II’s funding was used to cover past due employment taxes, workers compensation premiums, and other general working capital purposes.

Rather than force the company into liquidation to recoup its investment, however, Huntington doubled down, providing additional equity and debt capital to support working capital needs and exercising its lender rights to take an 80 percent ownership stake. By late 2012 HC II had invested a total of $5.65 million in DCS. Huntington brought in a new COO and controller and, after implementing operational improvements including additional financial controls, territory realignment, analysis of contract margins, and the disposition of non-essential equipment, moved in December 2012 to have substantially all of DCS’s assets acquired by another janitorial company in Southern California.

The lock for HC II was that DCS’s social impacts continued to be impressive and “much was at stake,” according to Miller. When HC II first invested in 2009, DCS had 919 employees, of whom 73 percent resided in LMI communities. That number has risen further, to 1,026 employees as of December 2012. Miller explains: “Our thinking was financial first. But as the company evolved and cash flow constraints led to increasing challenges, our focus shifted from purely financial to consider much more the employment aspect. There are 900 people living in LMI areas out there. We wanted to make sure we were able to support them.”

Moreover, Huntington suffered from being a minority investor at first. The firm’s advice to the company was not binding. Management could choose to be receptive, and opted not to be.

Huntington concedes that its usual formula, which generates social outcomes primarily as an outgrowth of investment excellence, had been subverted. “Diamond was one of those examples that was clearly an impact investment going in and was one of our biggest challenges. But we would have done it without impact potential,” Bubnack argues.

DCS remains a difficult investment for HC II. While revenue still tops $25 million, HC II’s total exposure was valued at $5.73 million at March 31, 2013, for an IRR of -17.2 percent. Huntington Capital has a 9.46 percent loss ratio across the whole portfolio; an impressive percentage for any mezzanine debt fund. The Huntington team expects that their significant effort to turn DCS around will result in a return of capital.

**Investment Profile: Advanced Structural Alloys**

Advanced Structural Alloys is a manufacturer of highly customized aluminum products for a range of market segments, based north of Los Angeles, in Oxnard, California. The company was on the verge of bankruptcy when HC II first invested in June 2009, due to a downturn in the economy and a heavy debt load. The funding was used to acquire approximately $13 million in loans to the company from its then senior lender at a 90 percent discount and leased equipment at similarly high discounts from fair market value.

HC II’s initial $1 million loan and $750,000 equity investment, alongside another private equity firm, recapitalized ASA, restructured its debt, provided new working capital, and placed Huntington in a controlling position, with 52 percent ownership. It also helped save jobs at the company and keep the business operating.

Huntington brought in the current senior lender and was a key point of contact with GE Capital in funding the company’s equipment needs. In 2010, when ASA was struggling with cash flow, capital expenditure needs, and an underperforming accounting function, Michael Chen, one of Huntington’s associates, became the interim CFO at the company, spending four days a week in
Oxnard. Michael’s focus on cost containment significantly improved cash flow through revenue growth, operational efficiencies, and margin enhancement.

Huntington also worked with the company on a strategic plan to transform itself from an automotive parts manufacturing company into a technology and clean energy/alternative fuel-based company, partly through the development of aluminum cylinders that store CNG. ASA has since entered into a strategic partnership to develop large-diameter CNG cylinders for heavy-duty vehicles, creating the world’s first large diameter Type III CNG Cylinder and positioning its manufacturing capabilities to build a range of products focused on the segment.

Recognizing the need for additional capital to continue to grow the business, Huntington led a recapitalization of ASA in the first quarter of 2012. HC II provided additional working capital and resources for new machinery through another $1.25 million equity investment and by converting warrants, mezzanine debt, and accrued interest into equity. By reducing overall leverage, HC II was readying the business to attract outside institutional interest in support of expected growth and a possible exit. HC II had extended its ownership to 58.25 percent.

ASA is an example of a turnaround deal for HC II, and of the firm at its most active, both as a provider of creative financing and as an owner. HC II saved 57 jobs when it invested in ASA. The company has grown to a total of 98 full-time employees at December 31, 2012, with approximately 80 percent residing in LMI communities.

ASA’s economic fundamentals are strong. The company’s EBITDA has increased from $712,000 at the time of investment to a trailing 12-month EBITDA of $1.7 million at March 31, 2013. As of March 31, 2013, total realized and unrealized proceeds from HC II’s investment in ASA were valued at $6.79 million, representing a 24.19 percent IRR and a 1.74x cash multiple.

THE RESULTS

Interestingly, almost exactly half of HC II’s financial performance can be attributed to debt-like returns, and half to equity-like returns, reflecting the diversity of the firm’s approach to impact investing.

At March 31, 2013, HC II had achieved a 25.6 percent gross IRR, a 13.78 percent net IRR, and a 1.35x net cash investment multiple since inception, placing the fund in the top quartile of all mezzanine private equity funds from vintage year 2008.2 HC II had returned to its investors cumulative distributions representing 37 percent of all called capital and 29 percent of all committed capital. Two additional exits at the time of writing, in October 2013, have increased those distributions to 48 percent of all called capital and 38 percent of all committed capital.

As a firm focused on delivering market rates of return, this is what success looks like. But Huntington Capital would not be an impact investor if financial performance was its only barometer of success. Fortunately, in this rare case, there exists a benchmark with which to assess the firm’s social impact, providing concrete evidence that HC II has in fact succeeded in delivering exceptional financial and social returns.

Specifically, Huntington counts among its peers the other GPs responsible for the investment of GSIF, managed by Hamilton Lane, the CalPERS investment targeted to California’s underserved communities. GSIF publishes a social performance report each year, at the portfolio level, which effectively aggregates the social performance of all GSIF GPs and co-investments and provides a baseline with which to compare HC II.3

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2 According to March 31, 2013 benchmark data from Cambridge Associates LLC U.S. Private Equity Index® and Benchmark Statistics Report

At June 30, 2012, the latest reporting period for which a comparison with GSIF is possible, the companies active in HC II’s portfolio (i.e. not exited) employed 2,741 workers, up 30 percent from 2,114 at the time Huntington invested. Other highlights of HC II’s social performance include:

• 51 percent of all HC II portfolio company facilities are located in LMI areas. This compares to 33 percent of all GSIF portfolio company facilities located in LMI areas.

• 45 percent of HC II portfolio company employees reside in LMI communities. By comparison, 34 percent of all portfolio company employees in the GSIF portfolio reside in LMI communities.¹

• 23 percent of HC II portfolio company key managers are women and 30 percent are ethnic minorities (non-white). In the total GSIF portfolio 31 percent of key managers are women and 20 percent are minorities.

HC II has also exceeded its own benchmarks, with 80 percent of capital deployed in a manner consistent with Huntington’s definition of social impact, against the objective of 60 percent.

CONCLUSION
Huntington could be mistaken for any other mezzanine growth equity investor in the U.S. on the basis of financial performance alone; in fact, it would be a particularly successful one. Yet Huntington has pursued and delivered excellent social performance alongside financial return.

The firm therefore provides a unique insight into the structures and practices that integrate the delivery of social impacts into an unambiguously financially-driven fund. In the case of Huntington, these core elements include a combination of character, investment strategy, and accountability.

• CHARACTER: Huntington was predisposed to seeking social impact alongside financial return, and targeting portfolio companies with shared values. This approach was driven by its founders’ unique experiences, including banking in emerging markets and the use of private investment explicitly as a tool for economic development. Reflecting these qualities, Huntington’s first fund was registered as a SBIC, part of a U.S. government program created to provide capital where traditional sources have been limited, paving the way for Huntington’s emergence as an impact investor in HC II.

• INVESTMENT STRATEGY: Huntington’s particular niche – targeting underserved SMEs and using financial tools that realize value with or without exits, in a racially diverse part of the U.S. – positioned HC II to meet the social objectives of a group of well-aligned LPs.

• ACCOUNTABILITY: The mission and expectations of LPs – and of Huntington itself – have been translated into a concrete set of measurable social objectives that are faithfully implemented, tracked and reported.

POST SCRIPT
Huntington is currently building on the success of HC II to launch Huntington Capital Fund III, LP, with a target size of $125 million. Citi Community Capital, a new investor, has committed to leading the fund, along with repeat investors Invesco (for CalSTRS), Hamilton Lane (for the Nevada Capital Investment Corporation), Union Bank, and the F.B. Heron Foundation. In

¹ **Does not include Eaton Veterinary Pharmaceutical since they don’t provide employee zips and wages**
addition, the fund has raised capital from a group of leading institutional investors including Morgan Stanley’s Global Sustainable Finance Group, HSBC and Hollencrest Capital (an institutional manager of large family offices, foundations and insurance companies).

Huntington Capital is taking its social performance tracking and reporting to the next level in HC III and has become a founding network member of the Global Impact Investing Network (GIIN). The Fund is now listed on the Impact Reporting and Investment Standards “IRIS” registry, and is rated by the Global Impact Investing Rating System (GIIRS).

Huntington will also implement a formal survey of social metrics, using GIIRS, for each of its potential investees during the due diligence process. With banks investing in HC III, the burden of proof in meeting CRA criteria is again heightened and Huntington is gearing up for the challenge.

The firm is being thoughtful about where, precisely, it can have more impact. Bubnack explains:

“We are trying to listen to our investors and other thought leaders to bring more attention to the front end of our deal process. How can we improve our game in the next deal – and continue to be on the cutting edge of impact investing – while continuing to achieve above-market-rate returns? In most situations we are not a control investor, so our biggest negotiating leverage is at the term sheet stage, where we can incorporate more impact-oriented expectations and future governance. We need to look at what companies are doing to provide health care, employee training and better jobs along with community outreach programs.”