INDEPENDENT SPONSORS:

A Critical and Evolving Deal Flow Channel

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Independent Sponsor: A Channel in Evolution

Over the past decade, the independent sponsor model has become increasingly prevalent in the lower middle market, with investors interested in private companies actively seeking to co-invest with prominent or promising sponsors as a supplement to direct, brokered, or other deal flow channels. Potential capital partners include all major segments of the private investor spectrum – private investment funds, family offices, high-net-worth individuals, and institutional investors.

"Independent sponsor" is an expansive and evolving category that may be understood to cover any transaction in which a sponsor first sources, diligences, and negotiates the recapitalization or buyout of an acquisition target and then subsequently seeks financing partners to close the transaction. As such, the independent sponsor model is essentially the inverse of the blind pool, where the fund sponsor first obtains binding investor commitments before sourcing and closing investments.

The discussion herein is primarily geared toward independent sponsors, their potential arms-length capital partners, and other related industry professionals. The below discussion is not, however, directed toward commingled private investment funds, captive independent sponsors who have a long-term, single limited partner, or one-stop mezzanine capital partners. The discussion below regarding "typical economics," draws from all of our arms-length independent sponsor transactions in the most recent 18 months, and it should be appreciated that there are nearly as many transaction types as there are capital partners, such that most of the "typical economics" discussions in the market represent apples-to-oranges comparisons.

Moore & Van Allen is an active participant in the evolving independent sponsor space and regularly represents sponsors, their investors, and financing partners to these transactions across a range of industries. We invite any interested parties to contact us for additional market information.

What's In a Name?

Independent sponsors generally fall under one or more of three categories – experienced operators, private equity professionals, and other industry veterans with sector-expertise and access to "off-market" deals. While fundless private equity professionals have historically used the independent sponsor model as a stepping stone to raising a blind pool – i.e., a waypoint to show performance – the model has gained broad acceptance as a viable, and progressively preferable, alternative to conventional investment structures.

A successful sponsor usually has extensive industry contacts and operational or finance expertise that enable it to credibly engage with target management without prearranged acquisition capital and to market transactions to investors as special situation opportunities.

The sponsor often seeks to leverage its proprietary network of founder and sell side advisory relationships in the less efficient lower middle markets, where exiting founders may value legacy over purchase price and personal relationships are key. The success or failure of a given transaction often turns on the individualized merits, track record, and relationship rolodex of a particular sponsor.

Market Drivers

Against the backdrop of intensifying competition in the private equity markets, ubiquitous ultra-cheap debt, and record levels of dry powder in investment funds worldwide, asset prices are being bid up in a low-yield environment, and investors with alternative asset allocations are increasingly turning to off-market opportunities. A confluence of factors is also driving fundamental structural changes to the sector, including:

- Fundraising cycles: Spin-out management teams and other private equity executives face elongating fundraising cycles and intensifying regulation when seeking to establish a first-time fund.

- Shifting GP-LP bargaining power: Relative bargaining power has shifted away from asset managers in favor of institutional investors who are progressively less fee tolerant and increasingly exercise collective leverage through associations that advance investor-friendly best practices.

- Partnering with PE funds: Private equity funds increasingly turn to co-investing with independent sponsors as a supplement to the conventional deal flow channels of auctions, buy-side intermediaries, and direct outreach.

- Investors going more direct: Investor interest in direct investing has grown, with family offices in particular seeking to invest with discretion while understanding the value of full-time private company investment professionals.

Value Proposition to Investors

- Costless deal optionality: Sponsors offer investors true, costless deal optionality by first sourcing and diligencing opportunities before offering them on a discretionary "take-or-pass" basis.

- Accessing less efficient markets: The overall private equity markets have matured, leaving many of the better opportunities in the less efficient, less trafficked lower middle market where independent sponsors are most prevalent.

- Portfolio concentration: Sponsors' interests are generally highly aligned with investors' interests because the sponsor's profit participation typically derives from a much smaller portfolio than that of a fund manager, so that the price of mediocre performance or failure is unacceptably heavy.

- Specialized & hands-on: Sponsors typically bring deeply vertical specialized knowledge to bear by taking an operational or other hands-on role with the portfolio company, thereby increasing the likelihood of market outperformance and an attractive exit.

Value Proposition to Sponsors

- Longer hold periods: Partly due to the growing number of retiring baby boomers who founded companies and heavily weight legacy considerations, sellers increasingly look towards buyers who have a long-term interest in their company, and sponsors and their investors are typically able to hold a company indefinitely.

- Flexible mandate: At the potential expense of increased risk of style or size drift, sponsors can be more flexible in investment type, sector, or size and can also establish a more bespoke investor base for each of their portfolio investments.

These and other factors will continue to drive the evolution of the model and pressure the standardization of structuring and offering terms.

Anatomy of an Independent Sponsor Transaction

The independent sponsor market is still in the early stages of maturation – there is no one-size-fits-all deal structure or standardized set of investment terms. Every deal is different, and its structure depends dramatically on the pedigree of the sponsor, the uniqueness of the opportunity (including the perception of valuation relative to the market), and the sophistication and appetite of the investor base.

- Significant variation: Transaction terms and structures vary considerably depending on the nature of the deal and the post-closing involvement of the sponsor. The sponsor and its capital partners will usually co-invest through a single-asset limited liability company whose operating agreement governs the post-closing relationship of the parties.

- Marriage of PE/VC-style investing: In substance, the investment vehicle and attendant contractual architecture marry a single-warehoused-asset investment fund with venture capital-style restrictions on early-stage company founders (with benchmarked and/

or durational equity vesting schedules and forfeiture on disassociation events). Generally, these vehicles have tiered distribution waterfalls keyed off of investor preferred returns which are typically formulated as a minimum IRR or multiple of invested capital.

Typical Economics to Sponsors

- Closing Fee: 1% - 5% of enterprise value, usually equaling $200k - $600k (often subject to a hard dollar cap and collar); however, depending on the investor base, this fee may be rolled into the sponsor's equity investment in the portfolio company.

- Annual Management Fee: 3% - 5% of EBITDA, often subject to a cap and collar of $250k - $500k.

- Promote/Carried Interest: Ranging from a 20% carry (for proven sponsors) to a 10% - 15% carry above a 1x or 8% preferred return, often with second-tier carry of 20% - 25% above a 2.5 - 3x preferred return to further incentivize stellar performance, in each case benefiting from a catch-up provision.

Common Sponsor Restrictions

- Time and Attention: Generally required to devote a specified amount of business time and attention to the portfolio company, ranging from the time and attention reasonably necessary to satisfactorily perform the management services to a majority or substantially all of the sponsor's business time and attention, in each case for a period of 2 - 3 years following the closing.

- Equity Vesting: Ranges from no vesting to vesting over a 3 - 5 year period, often front-loaded with a combination of performance benchmarks and time-vesting elements.

- Promote Forfeiture: Where for cause termination or disassociation without good reason, accrued and unpaid promote is generally forfeited.

- Promote Vesting Acceleration: Where termination without cause, disassociation with good reason, or a sale/change of control transaction or liquidation, the promote vesting schedule generally accelerates.

- Other Activities: Generally prohibited from engaging or investing in any outside activities that directly or indirectly compete with the portfolio company.

Additional requirements may be imposed on the sponsor's conduct of the business depending on the idiosyncrasies of the deal and any special requirements of the equity or debt financing partners (such as leverage limitations) or the seller (such as the treatment of legacy employees).

Notably, the foregoing summary contemplates arm's-length independent sponsor structures. However, the market is also populated with "friends and family" funds where investor economics often look more akin to structured equity or debt and the restrictions on and obligations of the sponsor tend to be significantly more sponsor friendly.

Pre-Closing Lifecycle of an Independent Sponsor Transaction

- Pre-LOI stage: At the outset of a transaction, the sponsor is often running a set of related but independent parallel processes. In the pre-letter of intent phase, the sponsor is negotiating preliminary deal terms with management and founders, conducting preliminary legal and financial due diligence, developing a post-transaction growth strategy, identifying any financing-related issues, evaluating alternative capital structures, and preparing a "no-names" investor teaser outlining the opportunity.

- Post-LOI stage: Following execution of the letter of intent and the imposition of a no-shop, the sponsor finalizes the legal and financial due diligence, negotiates its economics, approaches prospective financing partners with the teaser, negotiates equity and debt underwriting terms, solicits term sheets, and prepares a full confidential information memorandum. Because the sponsor's economics depend substantially on the identity of the financing partners, the sponsor typically spends a substantial portion of its pre-closing time sourcing and engaging with different parties offering different capital structuring options. Prior to closing, the sponsor is continuously selling its pedigree, experience, relationships, and track record to each stakeholder in the transaction, casting the transaction as a proprietary, "off-market" diamond in the rough, evolving a compelling post-closing growth plan and story (including the identification of possible add-on acquisition opportunities), and seeking to run an efficient capital raising process that maximizes both its economics and the probability of a successful closing.

- Both good sponsors and investors are selective: As with all true special situation opportunities, the identity of the parties largely determines the quality of the outcome. The sophisticated sponsor will carefully match the right capital to the right opportunity on balanced terms, while the sophisticated financing partner will know to view the sponsor as a value creation partner and real deal flow value-add, rather than simply a cost of doing business or a glorified broker.

Pitfalls of an Independent Sponsor Transaction

Even assuming efficient and satisfactory commercial negotiations, the sponsor must remain cognizant of a landscape riddled with regulatory landmines that can explode even the most carefully crafted deal.

- Regulatory registration or penalty: Depending on the nature of the investment vehicle established for the transaction, the sponsor may be subject to federal or state investment adviser registration, regulation, or reporting obligations, for which the failure of non-compliance can carry both civil and criminal penalties. Further, depending on the manner in which the closing fees are structured and the nature and extent of the sponsor's post-closing involvement in the company's management, the sponsor may face broker-dealer registration requirements.

- Taxes: In terms of tax optimization, unless properly structured the sponsor's equity participation may not receive capital gains treatment or be respected as a profits interest by the IRS.

- Clawbacks: Where the sponsor is entitled to receive early distributions of carry that are subject to a claw-back obligation on a later true-up, the claw-back mechanics must contemplate whether the sponsor's return of capital obligation is calculated net or gross of taxes and at what marginal rate; otherwise, the sponsor may be out-of-pocket for personal taxes paid on portions of the carry eventually returned to investors.

- Investor tax issues: Complex tax issues can also arise in relation to the participation of U.S. tax-exempt and foreign investors that may be sensitive to UBTI and IRS reporting obligations, and these concerns generally must be accommodated during the initial structuring phase.

Challenges in the Independent Sponsor Model

Independent sponsors have some challenges that are typically not faced by commingled fund sponsors.

- Potentially volatile revenue: Without a predictable revenue stream to offset expenses, sponsors may find difficulty growing and compensating a team – in addition to other types of long-term planning.

- Closing investments: Sellers and their advisers may penalize an independent sponsor's ability to close a transaction. In addition, without committed capital, a sponsor may still fail to raise enough capital or to attract a desirable investor base – even after execution of a letter of intent.

- Investment bias susceptibility: As highlighted in the value propositions to sponsors, independent sponsors tend to have more investment flexibility. If not pre-committing to a philosophy, strategy, or specific criteria, sponsors may be more susceptible to fads or overconfidence when venturing outside the guardrails of past successes.

- Entity planning: Depending on factors such as the sponsor's expectations of generating more profit from capital gains versus ordinary income and its intention to one day raise a commingled fund, structuring options will vary considerably.

A Final Word

While the list of key deal terms is discrete, deal structuring and negotiation is complicated by the unique nature of each independent sponsor transaction and the lack of developed market benchmarks.

Notwithstanding the challenges, however, the independent sponsor model is one of the few attractive alternatives to conventional private equity funds that is open to institutional investors, family offices, and high-net-worth individuals alike, and increasing amounts of capital can be anticipated to court these investment professionals.

We anticipate that investor allocations to independent sponsor transactions will continue to grow and that the market will mature and evolve standardized terms and best practices, in much the same way that the private equity industry matured over the last few decades.

We look forward to continuing to represent the full spectrum of market participants on all sides of the independent sponsor ecosystem and welcome inquiries and dialogue with all interested parties.

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