



Independent Sponsors: How To Leverage This Valuable Channel For Transactions

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INDEPENDENT SPONSORS: HOW TO LEVERAGE THIS VALUABLE CHANNEL FOR TRANSACTIONS

In an ultra-competitive deal market, investors continually look for attractive opportunities to deploy additional capital. While “independent sponsors” have been around for many years, the number of independent sponsors is at an all-time high and their credibility continues to climb.

At the same time, there is an increasing number of debt and equity capital partners that predominately or solely focus on independent sponsor transactions. And the independent sponsor community continues to evolve in sophistication and market share of deals closed.

We welcome anyone interested in this community — as an independent sponsor or capital partner — to attend McGuireWoods’ 2017 Independent Sponsor Conference (www.independentsponsorconference.com).

This installment of our independent sponsor publication series focuses on different types of independent sponsors, how they are compensated and deal-flow development.

Who are independent sponsors?

Independent sponsors come from a variety of backgrounds but share the same objectives — sourcing interesting investment opportunities, driving a company’s operational improvement and creating significant equity value.

Independent sponsors generally fall into one of three categories.

1. **Former “Funded” Private Equity Professional** – Whether it is a less experienced professional who struggles to see a path to making partner or a senior partner tired of the fundraising process or who prefers to refocus on a smaller number of portfolio companies, many independent sponsors come from established and traditional private equity funds. These independent sponsors understand how private equity funds operate, contribute deep expertise in structuring and negotiating transactions, and enjoy spending the majority of their time on sourcing opportunities and creating value.
2. **Experienced Executive** – Another type of independent sponsor is a former executive who has proven expertise in a specific industry and a broad list of industry contacts and other executives who can add significant value to an investment. These individuals find opportunities not broadly marketed and their industry experience and network help drive growth at the company.
3. **Successful Entrepreneurs** – This group of independent sponsors includes entrepreneurs who have built thriving companies from the ground up and successfully exited. Similar to executives, these independent sponsors often lack direct training at a private equity fund, but they bring proven experience operating companies from the “front lines” and are reliable resources for growing a business. They usually have interesting deal-sourcing capabilities with a strong focus on organic sales growth.

How are independent sponsors compensated?

With the proper incentives and structure, independent sponsors are an effective resource to identify interesting investment opportunities, structure transactions at attractive valuations and drive above-average returns.

There are generally three types of compensation negotiated in independent sponsor transactions.

1. **Acquisition Fees** – Acquisition fees usually range from 2 percent to 5 percent of enterprise value depending on the size of the transaction. Among other things, these fees are used to reimburse travel and other costs necessary to source and close a transaction, which often takes one to two years, and to compensate the independent sponsor for due diligence and structuring efforts.

Enterprise Value (EV)	Acquisition Fee
\$0 - \$10mm	3% - 5% of EV
\$10mm - \$25mm	2% - 3% of EV
>\$25mm	1% - 2% of EV

As with typical private equity funds, many independent sponsors pursue add-on acquisitions for their platform companies. The independent sponsor typically receives additional compensation for sourcing and executing these transactions, which range from 1 percent to 3 percent of the add-on company's enterprise value. It is important to be aware of the regulatory landscape and its potential impact on an independent sponsor's ability to receive an acquisition fee; therefore, consult legal counsel to comply with various regulations that apply to these fees.

2. **Management Fees** – Management fees independent sponsors earn from active deals fund their operating budgets. The primary components of a management fee usually include a fixed dollar amount (i.e., \$200,000 to \$500,000) or a percentage of EBITDA (i.e., 3 percent to 5 percent). The most common structure is a combination of the two components so that the independent sponsor has the potential to increase near-term income growth. In this structure, independent sponsors earn the greater of a fixed amount or a percentage of EBITDA.
3. **Equity Ownership** – The most heavily negotiated part of an independent sponsor's compensation structure is generally the equity ownership, commonly referred to as “the promote” or “carried interest.” Capital partners that enjoy the most productive and profitable deal flow from independent sponsors embrace promote structures that reward independent sponsors for success.

Promotes can be structured in many ways. However, the most common structures fall into two buckets.

1. **Simple Promote** – Most independent sponsors prefer a simple structure for the promote. In this case, a capital partner has a priority on its equity investment such that once it receives its invested capital plus a preferred return — usually ranging from 5 percent to 8 percent — the remaining proceeds are split 80/20 to the capital partner and independent sponsor.

This structure is very easy to understand and does not introduce complexity if additional capital is required for add-on acquisitions or organic growth. In addition, the simple promote creates an incentive for the independent sponsor to create value quickly and efficiently to minimize

misalignment of interests. As detailed below, some capital partners require the ability to generate higher returns before sharing proceeds with the independent sponsor.

2. **Tiered Promote With Multiple of Investment Capital Hurdles** – In a tiered promote with multiple of investment capital hurdles, an independent sponsor earns more from the promote as the returns on invested capital for the capital partner escalate.

For example, a capital partner will receive 100 percent of the proceeds from an investment until it receives its initial investment plus a preferred return, similar in nature to the simple-promote structure. After that, proceeds often are split between the capital partner and independent sponsor as follows:

- 100 percent catch-up to the independent sponsor until he receives 10 percent of the profits distributed;
- 90 percent to the capital partner and 10 percent to the independent sponsor until the capital partner receives one-and-a-half times the return on its investment;
- 100 percent catch-up to the independent sponsor until he receives 15 percent of the profits distributed;
- 85 percent to the capital partner and 15 percent to the independent sponsor until the capital partner receives two times the return on its investment;
- 100 percent catch-up to the independent sponsor until he receives 20 percent of the profits distributed;
- 80 percent to the capital partner and 20 percent to the independent sponsor until the capital partner receives three times the return on its investment;
- thereafter, 75 percent of the remaining profits to the capital partner and 25 percent to the independent sponsor.

In this structure, the capital partner captures a larger percentage of profits in low-return scenarios and rewards independent sponsors for outsized returns, creating a strong incentive structure for the independent sponsor to generate above-market returns. This structure also can be more complicated to understand and implement, particularly when additional capital is required for additions and growth.

A common mistake when negotiating economics with an independent sponsor is to view the independent sponsor as a transaction cost, rather than an asset that can effectively work as an extension of the capital partner. The best independent sponsors reduce the amount of time a capital partner must dedicate to an investment and generate top-tier returns.

How is deal flow developed from independent sponsors?

There has been growing interest in developing deal flow from the independent sponsor channel over the past few years, but many capital partners have struggled to break into this growing and vibrant investment model. Success most often is a result of capital partners focusing on the following:

- approaching the independent sponsor as a true partner and not a transaction cost;
- providing independent sponsors access to senior-level decision makers to vet opportunities quickly as opposed to business development-focused professionals who may not view independent sponsors as true partners and appreciate the story behind a transaction that may not be “down the fairway”;

- offering suggestions for other capital partners when an opportunity does not fit;
- learning to work effectively and efficiently with independent sponsors in closing transactions;
and
- developing an effective process for partnering with independent sponsors to drive value after the close.

In generating investment opportunities from independent sponsors, it is important to realize that the community is still small enough that independent sponsors routinely share experiences and feedback about various capital partners. As a result, it is easy for a capital partner to build a great reputation quickly in this community, resulting in a high number of quality investment opportunities from multiple independent sponsor sources. At the same time, a few missteps can just as easily create a bad reputation in this marketplace.