Side-By-Side Comparison of Key Independent Sponsor and Searcher Terms

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There is often a blurring of the lines between independent sponsors and searchers engaged in a traditional search as participants in lower-middle market mergers and acquisitions transactions. The table below presents a side-by-side comparison of the key economic and governance terms in arms-length lower-middle market M&A transactions. It should be noted here, however, that searchers will often take a hybrid approach by borrowing what would otherwise be an independent sponsor term, and vice versa. Independent sponsors and searchers should consult with experienced legal counsel before finalizing the below terms with their investors.

QUESTIONS/ISSUES	INDEPENDENT SPONSORS	SEARCHERS
Generally, what is the fundamental difference between Independent Sponsors and Searchers?	Independent Sponsors typically view a transaction as a private equity fund or private equity professional would view it – as a platform or as one of many similar investments. Independent Sponsors generally consider themselves as investors rather than operators. The Independent Sponsor typically does not become the CEO of the target, rather, Independent Sponsors look for a strong management team to stay on post-closing or engage search firms to help locate and hire a new CEO.	Searchers typically view the transaction as an entrepreneur or founder would, where he or she becomes the CEO of the target *(or other "c-level" executive where there are multiple Searchers in the same deal).* Searcher deals are often considered "entrepreneurialism by acquisition." As discussed below, the Searcher's equity vesting is tied to his or her success in this role.
What is the difference between Independent Sponsor waterfall economics and Searcher waterfall economics?	Independent Sponsors typically receive common or "Class P" equity interests which receive a 10%-30% "carry" or "promote" on the invested capital, subject to performance based hurdles tied to IRR or MOIC. ***Note:*** Some Independent Sponsors successfully negotiate for venture capital style economics tied to a pre-money valuation of the target. ***Note:*** See Annex A for a side-by-side comparison of typical Independent Sponsor and Searcher Waterfalls.	Searchers typically receive common equity subject to three tiers of vesting (as described below). Searcher groups typically earn 30 percent of the common equity while solo Searchers typically earn 20 to 25 percent. ***Note:*** Some Searchers successfully negotiate for equity credit tied to the amount of any SBA debt they guarantee. ***Note:*** Some Searchers also successfully negotiate for venture capital style economics tied to a pre-money valuation of the target. ***Note:*** See Annex A for a side-by-side comparison of typical Independent Sponsor and Searcher Waterfalls.

Generally, what is the difference between Independent Sponsor carry / promote and Searcher vesting?

Independent Sponsors typically receive a "carry" or "promote" on the invested capital ranging from a base 10% carry to a max 20% – 30% carry upon the achievement of certain financial hurdles. From the 10% base, this carry typically increases according to thresholds and hurdles such as those set forth below:

- first, a 10% – 15% carry above 1.0x – 2.0x multiple of invested capital ("MOIC") and x% preferred return;
- then, to a second–tier carry of 15% – 25% above a 2.0x – 2.5x MOIC and x% preferred return; and
- finally, to a residual, third–tier carry of 20% – 30% above a 2.5x – 3.0x MOIC and x% preferred return.

Note: A carry in excess of 20% if often reserved for more experienced Independent Sponsors or Independent Sponsor transactions with a broad "friends and family" investor base.

Note: Most often, Independent Sponsor equity is not subject to vesting. If required, vesting is time–based over a 3 – 5 year period.

Searchers typically receive common equity subject to three tiers of vesting, as follows:

- **Tranche 1 (Closing):** Upon acquisition of the portfolio / target company;
- **Tranche 2 (Time-Based*):** Typically tied to a 4 to 5-year vesting schedule); and

  Note: Typically, immediately prior to the consummation of a sale event / change of control transaction all unvested time based vesting equity automatically and immediately vests.

- **Tranche 3 (Performance-Based**):** Typically tied to the achievement of performance benchmarks (e.g. IRR hurdles). Most often this tranche vests according to net investor IRR performance hurdles - which is often linear based vesting between a 20% and 35% IRR.

  ****Note:*** Performance vesting can also be based on MOIC benchmarks or a combination of IRR + MOIC (expressed as a "greater than" test).

Do either Independent Sponsors or Searchers receive a "catch-up" in the waterfall?

Yes, to further incentivize stellar performance, investors will often allow Independent Sponsors to benefit from a catch–up provision. A "catch–up" provision is a mechanism in the waterfall which catches the Independent Sponsor up to the applicable percentage to be received by the Independent Sponsor in the next step of the waterfall.

Note: While Independent Sponsors typically receive a "catch-up" in the waterfall, this right is often the first item that an Independent Sponsor will trade for more favorable hurdle rates or higher management fees.

Some Searchers are able to negotiate with the other investors for a "catch-up" in the waterfall, however, this right is not seen as often in Searcher transactions as in Independent Sponsor transactions.

Note: Also, as in Independent Sponsor transaction negotiations, this right is often the first item that a Searcher will trade for more equity or a higher salary.

What is the typical preferred coupon rate in Independent Sponsor and Searcher transactions?	Preferred return is generally a non-compounding rate equal to 5% to 9% (most often 8%) for experienced Independent Sponsors and 6% to 12% for emerging Independent Sponsors. ***Note:*** Preferred returns subject to an annually compounding rate are generally on the lower end of the above ranges.	Preferred return accrues daily and is generally a non-compounding rate of 5%-9% (most often 8%). ***Note:*** Preferred returns subject to an annually compounding rate of return are generally on the lower end of the above range.
Do Independent Sponsors or Searchers take closing fees?**	If permitted to do so under applicable law, Independent Sponsors receive a 1% – 5% of enterprise value closing fee, often subject to a hard dollar cap and floor; however, depending on the investor base, this fee may be rolled into the Independent Sponsor's equity investment in the portfolio / target company. *****Important Note:*** **Independent Sponsors should consult with experienced legal counsel before taking a success-based transaction fee, however, as both federal and state securities laws may impact the Independent Sponsor's ability to accept success based transaction fees. The consequences can be severe for failure to comply with these regulations.**	Typically, Searchers do not take closing fees. *****Important Note:*** Searchers should consult with experienced legal counsel before taking a success-based transaction fee, however, as both federal and state securities laws may impact the Searcher's ability to accept success based transaction fees. The consequences can be severe for failure to comply with these regulations.
What is the difference in periodic compensation / salary for Independent Sponsors and Searchers?	Independent Sponsors typically receive a management fee in the range of 3% – 5% of target adjusted EBITDA. This annual management fee is typically paid quarterly in arrears and tested on a trailing twelve months basis during the term of the underlying management agreement, often subject to a hard dollar floor and cap (e.g., $250k – $750k, with outliers on the upper end for high-potential, well-connected Independent Sponsors with track records). ***Note:*** Management fees payable to less experienced Independent Sponsors are more often subject to smaller caps and no floor.	Salary and severance for Searchers vary widely depending on size/growth of business and by industry. Typically in the range of $150k to $450k with incentive based bonus compensation sometimes available. ***Note:*** Some Searchers are able to negotiate for management fees in lieu of a more traditional "fixed" salary. These amounts vary depending on size/growth of business, and can be as high as 3% – 5% of target adjusted EBITDA – however, this is atypical.

Is the carry or the vested equity issued to Independent Sponsors or Searchers subject to redemption or claw back provisions?	Typically, upon the occurrence of certain "Cause" events (tied to the management of the company or the Independent Sponsor's role on the board), the Independent Sponsor's accrued and unpaid promote is generally forfeited.	A Searcher's vested equity (if applicable) is typically redeemable at (a) the lesser of fair market value (FMV) or cost upon a for "Cause" termination or if he or she resigns without "Good Reason"; or (b) FMV for any other termination or resignation. ***Note:*** Sometimes, though not often, a Searcher's vested and unvested equity will be forfeited upon a for "Cause" termination or if he or she resigns without "Good Reason".
What is the difference in the governance of a portfolio / target company for Independent Sponsor and Searcher led companies post-acquisition?	Post-acquisition, an Independent Sponsor led company typically has a board of managers, with the Independent Sponsor controlling two (2) to three (3) of the five (5) board seats. ***Note:*** When Independent Sponsors bring in outside institutional investors, often times the company has five (5) board seats with the Independent Sponsor controlling two (2) board seats, the institutional investor controlling two (2) board seats, and one board seat filled by an independent director / manager.	Post-acquisition, a Searcher led company typically has a board of managers, with the Searcher controlling one (1) of the five (5) board seats. ***Note:*** Searchers are sometimes successful negotiating for control or joint control of the board with their investors.
What is the difference in the other M&A activity that Independent Sponsors or Searcher are permitted to undertake post-acquisition?	Independent Sponsors are generally prohibited from investing in any businesses that directly or indirectly compete with the portfolio / target company. ***Note:*** More experienced sponsors, especially those with track records and multiple Independent Sponsored investments, may be able to negotiate this restriction away. ***Note:*** Independent Sponsors are generally permitted to but other businesses that are not competitive with the portfolio company target / company.	Searchers are generally prohibited from engaging or investing in any outside activities that directly or indirectly compete with the portfolio / target company.

What is the difference in the amount of time and attention required by the portfolio / target company for Independent Sponsors or Searchers post-acquisition?	Independent Sponsors are generally required to devote a specified amount of business time and attention to the portfolio / target company, ranging from the time and attention reasonably necessary to satisfactorily perform the management services to a majority or substantially all of the Independent Sponsor's business time and attention, in each case for a period of 2 – 3 years following the closing.	The amount of time and attention required by the portfolio / target company for Searchers is almost always greater than for Independent Sponsors. Searchers are generally required to devote substantially all of his or her business time and attention to the portfolio / target company.
How is IRR calculated in Independent Sponsor and Searcher transactions?	Typically IRR is calculated based upon a Microsoft Excel XIRR formula calculation with the compounding rate of return running for entire period from date of contribution to date of return of contributed capital to investors.	Generally the same as Independent Sponsors. IRR is calculated as the annual compounding rate derived from the adjusted dates and actual amounts of search and acquisition capital invested and returned by an investment. See below, however, regarding "tax distributions".
What counts as a distribution for IRR Calculation in Independent Sponsor and Searcher transactions?	Cash distributions, ***tax distributions***, certain recycled distributable proceeds, certain in-kind distributions (if permitted), and certain deemed liquidations all count as a distribution for IRR calculation.	Generally the same as Independent Sponsors; however, in some Searcher deals *(and in traditional Search Fund deals),* "tax distributions" are excluded from the IRR calculation. If "tax distributions" are excluded, however, there is a corresponding provisions which serves as true-up upon an exit for the benefit of the searcher tied to the basis which is built up in the preferred investor equity over time. In which case the Searcher will get IRR credit for this built up basis benefit.

ANNEX A

Sample Waterfalls:

Below is a sample Independent Sponsor waterfall to reflect the above terms:

Step 1: 100% of distributable cash to the preferred investors until the preferred investors have received an amount equal to an 8% — accruing, not compounding — preferred return on their invested capital;

Step 2: 100% of distributable cash to the preferred investors until the preferred investors have received an aggregate amount equal to one times (1x) invested capital;

Step 3 — residual: 100% of distributable cash to the preferred investors and the common investors (pro rata based on their respective number of preferred and vested common units held);

PROMOTE:

Amounts otherwise allocated to the preferred investors in Step 3 are further allocated as follows:

Step 3A — catch-up: 100% of distributable cash to the Independent Sponsor until the Independent Sponsor has received 10% of the amounts received by the preferred investors in Step 1 above and this Step 3A;

Step 3B — carry level one: 90% of distributable cash to the preferred investors and 10% of distributable cash to Independent Sponsor until the preferred investors have received an aggregate amount equal to two times (2x) its invested capital;

Step 3C — catch-up: 100% of distributable cash to the Independent Sponsor until the Independent Sponsor has received 15% of the amounts received by the preferred investors in Step 1, Step 3A and Step 3B above and this Step 3C;

Below is a sample Searcher waterfall to reflect the above terms:

Step 1: 100% of distributable cash to the preferred investors until the preferred investors have received an amount equal to an 8% — accruing, not compounding — preferred return on their invested capital;

Step 2: 100% of distributable cash to the preferred investors until the preferred investors have received an aggregate amount equal to one times (1x) invested capital;

Step 3 — residual: 100% of distributable cash to the preferred investors and the common investors (pro rata based on their respective number of preferred and vested common units held);

VESTING:

Vesting upon the acquisition of the target. One-third of the Common Units issued to the Searcher shall vest as of the date on which the acquisition of the target is consummated.

Time-Based Vesting. One-third of the Common Units issued to the Searcher shall vest in equal monthly installments over the 5-year period following the date on which the acquisition of the target is consummated.

Step 3D — carry level two: 85% of distributable cash to the preferred investors and 15% of distributable cash to Independent Sponsor until the preferred investors have received an aggregate amount equal to two and one-half (2.5x) its invested capital;

Step 3E — catch-up: 100% of distributable cash to the Independent Sponsor until the Independent Sponsor has received 20% of the amounts received by the preferred investors in Step 1, Step 3A, Step 3B, Step 3C and Step 3D above and this Step 3E; and

Step 3F — carry level three: Thereafter, 80% of distributable cash to the preferred investors and 20% of distributable cash to Independent Sponsor.

Performance-Based Vesting. One-third of the Common Units issued to the Searcher shall vest based upon the achievement of the following IRR by the preferred investors:

Aggregate Preferred Unit IRR (%)	% of Performance Units Vested
Less than 15%	0%
Equal to or greater than 15% and less than 35%	A percentage calculated as follows: (20% - (35% - IRR)) / 20%
Equal to or greater than 35%	100%