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What To Expect From Independent Sponsors

An old investment model with new participants gaining traction in the lower middle market.

by David Working

Over the last few years, private capital has become increasingly creative in finding ways to make illiquid investments in operating businesses. Closed-end private equity funds and the firms that manage them used to be gatekeepers for these types of investments, but today, especially in the lower middle market, there exists a variety of avenues for buying into businesses. A generation of investment professionals, trained in transaction mechanics and fund operations from their private equity training, have opted to strike out on their own to find, evaluate, and execute deals. While some of these professionals have started their own private equity firms—and the number of new firms in the United States over the last five years indicates that this is a popular path—others have opted to employ a different mechanism for making investments: the independent sponsor model.

WHAT IS AN INDEPENDENT SPONSOR?

The independent sponsor—also known as a fundless sponsor, or a pledge fund—differs from traditional private equity primarily in the source and commitment of its capital. Traditional private equity raises a fund, usually closed-end (meaning it has a finite life to make investments and return capital to investors), from which the fund managers (the private equity firm and its investment professionals) deploy capital into investments. Independent sponsors, on the other hand, don't have committed capital. When an independent sponsor has a potential investment opportunity, it goes out to a limited group of private investors to raise the capital necessary for the equity portion of the transaction. Independent sponsors may have "soft" commitments—for instance, a family office that has informally promised to back their deals—but do not have an explicitly committed pool of capital from which to draw.

A search fund is a special instance of an independent sponsor. Usually one or two individuals, backed by an investor or group of investors, and usually young (late 20's or early 30's), "searchers" have a goal of identifying a stable lower middle market business, raising a combination of equity and debt (often including a seller note) to purchase the business from its retiring owner-manager, and then installing themselves as the new leadership of the business. Search funds have existed by different names for as long as there have been businesses, but they've increased in popularity over the last 15 years, primarily fueled by fresh MBA graduates and their exposure to Entrepreneurship through Acquisition (EtA) classes at Harvard, Stanford, and a select few other graduate business programs.

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Independent sponsors today are numerous enough to come in many different flavors. Some raise the equity for their deals in small chunks from a pool of as many as 50 small investors, while others may be backed by a single family or a handful of individuals. Some have extremely broad investment criteria (as broad as $1-5 million EBITDA manufacturing and services businesses anywhere in the United States) or very focused theses for their investment criteria (one firm specializes in small-footprint restaurant concepts in the Southeastern US). Despite their differences, the economics of the model are usually similar, rewarding the independent sponsor in two ways:

> **Their recent growth means that as a group, they vary widely in experience and capabilities, so an experienced transaction advisor familiar with the model and its participants can be valuable in guiding the process.**

Fees: Often, the sponsor is paid a transaction fee at close of the transaction for the work to find and execute the deal. We've seen sponsors take this fee in equity instead of cash and roll it into the deal. Almost always there is a management or monitoring fee, paid annually from the company, for the sponsor's time spent on administering the investment and sitting on its board.

Carry or Promote: As in traditional private equity, the independent sponsor earns a portion of the proceeds from the distributions from and eventual sale of the investment. Pricing varies – although the traditional 20% carry is common, the sponsor may earn a greater percentage if it's a compelling deal and it has shown a strong track record of success; similarly, the sponsor may lower its proposed carry for a first deal or if fundraising proves challenging. Also common is "tiering" returns, where the sponsor earns a base percentage of the proceeds, and then may earn a greater percentage if the investment clears certain return thresholds, or "hurdles."

IMPLICATIONS FOR BUSINESS OWNERS

Business owners and their advisors considering or involved in a sale to an independent sponsor should observe a few differences from a well-capitalized strategic or financial buyer. Sponsors are often in a chicken-and-egg situation: it's difficult to enter into exclusivity with a target without a clear pathway to raising the equity capital, and it's difficult to raise the equity capital without a deal under exclusivity. Business owners should ask probing questions about the viability of the capital and investigate the sponsor's track record—a track record of successful fundraises and closes is a strong predictor of future successes.

Many sponsors embrace the model because of the flexibility it provides them in market situations and cycles. A committed fund means the capital has to be put to work in a given amount of time, which can create unwelcome pressure to act regardless of market conditions. However, nearly all committed funds pay management fees, which allows private equity

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firms to build out some infrastructure (people and third-party support) to move quickly in the context of a single deal. Independent sponsors don't have a regular income stream from a committed capital source, and typically run leaner operations. This is fine right up until the pressure cooker of exclusivity, where the independent sponsor is trying to perform quality due diligence, secure debt financing, and complete its fundraising process with a team of one or two people. Business owners may notice periods of decreased responsiveness as the sponsor has one too many balls in the air, while an experienced independent sponsor will differentiate himself in this stage by conducting a smooth process without the fits and starts that being spread too thin can create.

The other aspect of not having a committed fund is that the expenses for the transaction—the legal, finance and accounting, and other third party diligence they may choose to perform—all comes out of pocket. In case of a busted deal, there's no recourse for the sponsor to recoup that spent money. As a result, independent sponsors will often try to backload spending on those providers until later in the process, when a deal on terms that make sense is within reach. Owners may notice and should not be alarmed by a flurry of late diligence or a legal team that enters the discussion halfway through the exclusivity period.

CONCLUSION

Not long ago, independent sponsors could get kicked out of a sale process led by an investment banker, simply because the lack of equity was seen as too great of a risk to closing to overcome. The landscape has changed; today, the model is much more established, with capable principal investors and professional service providers that cater to the unique needs of independent sponsors, and can represent an active and legitimate option for business owners seeking liquidity—especially in the lower middle market. However, their recent growth means that as a group, they vary widely in experience and capabilities, so an experienced transaction advisor familiar with the model and its participants can be valuable in guiding the process. **ZS**

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ABOUT ZACHARY SCOTT

Since 1991, Zachary Scott has assisted owners of privately-held businesses in the greater Pacific Northwest to plan and execute major business or ownership transitions by offering sell-side M&A and acquisition and investment advice. For more information on Zachary Scott, go to **ZacharyScott.com.**

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