THE RISING IMPORTANCE OF INDEPENDENT SPONSORS IN M&A

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Independent sponsors have risen to the forefront as a unique way of sourcing target companies for acquisition. Throughout 2016, we heard about the slowdown in the number of M&A deals reaching completion. Despite the slowdown, we also heard that credit remained available, that strategic acquirers had plenty of cash on-hand, and that private equity firms had dry powder that they needed put to work. The explanation for the decrease of completed deals largely centered around the lack of quality businesses available. The competition for quality targets caused multiples to be high, and the lower middle market emerged as a popular segment. Independent sponsors, due to their industry relationships, found hidden targets. All of these factors have coalesced to bring increased prominence to the role of independent sponsors in the M&A market.

So, what is an independent sponsor (also called fundless sponsors)? Independent sponsors put together an acquisition and typically have some level of investment in the acquisition, but they do not represent a particular fund. After locating a target, independent sponsors rely on their relationships with family offices, private equity firms, and mezzanine debt to fund the acquisition.

Many independent sponsors are ex-C-suite executives looking to make deals in the industry in which they have experience. Many developed a nest egg when private equity bought out their company, and they are looking to put industry knowledge to work. Other independent sponsors come directly from private equity and developed relationships and industry knowledge in a particular specialty. As the regulatory reporting disclosures and other investment restraints weighed down private equity, these industry insiders made the leap to becoming independent sponsors without an established fund. They have discovered relatively few barriers to entry.

Independent sponsors emerged in the early 1980s. There were two basic models – the search fund model and the fundless sponsor. With the search fund model, the independent sponsor raised $300,000 to $600,000 to fund the search and generally involved 12 to 16 investors. Once a target was identified, the independent sponsor returned to the investors to fund the acquisition. The fundless sponsor model operated more like traditional private equity. Fundless sponsors generally were experienced financial acquirers with a proven track record on past investments and extensive financial networks. Until 2008, both of these models were relatively rare, but the changing regulatory and investment environment has caused a rise in the importance of the independent sponsor.

The increased regulatory scrutiny, brought on by the heightened Dodd-Frank Act disclosure burdens, increased costs for private equity and reduced the amount of profit passed on to limited partners. During the Great Recession, many investors happily tied-up their resources in private equity funds with an expectation of greater returns. As deal making has accelerated over the last several years, this has driven-up the multiples that many targets received, making it more difficult to find an acquisition for a price at which an acquirer can make a good return. Many professionals in the industry have reported on the amount of dry powder that private equity has available. This is because when a limited partner makes a commitment to a fund, their resources are then tied-up, regardless of whether the private equity firm is able to find quality investments, and by definition, limited partners have no say over what investments are made. Limited partners found themselves in the position of wanting to make more of a direct investment and to have more control over the deal terms. In addition, family offices were also on the rise and, like limited partners, wanted more control over their investments. Independent sponsors, with their greater flexibility and lower regulatory scrutiny, became a favored alternative.

The greatest assets of the independent sponsors are their deal-sourcing ability and industry relationships. In an environment where good deals have become scarce, the ability to find these deals and bring the sellers to the table is a key asset. Private equity firms are competing with strategic acquirers who also have plenty of cash to deploy, and who have an insider's knowledge of their industry. Debt continues to be easily available, so access to capital is not determinative. Independent sponsors provide access to deal flow that is under the radar of big private equity firms and their personal relationships can go a long way in closing a transaction. Today's independent sponsors have knowledge of the current issues in their industry. They have connections to current management that can help a deal survive during troubled negotiations.

The potential targets in the lower middle market, those deals with a closing value of $25 million to $100 million, are particularly susceptible to the advantages of the independent sponsor. Many of these sellers involve family businesses facing obstacles in succession planning and are looking for the next generation of management. The founder is looking to sell, as a form of retirement planning, but also holds the continuation of the business as a fundamental goal. With independent sponsors who have industry expertise and connections, they are able to identify these potential targets. Independent sponsors tend to be much more involved with the sellers, engaging them in succession planning and then bringing investors a growth plan. Some independent sponsors plan to stay involved and bring to bear their managerial and operational expertise, bringing additional value to both the seller and the investors.

Independent sponsors are finding growing support from private equity firms. As they establish a history of successful dealmaking, private equity is viewing independent sponsors as an attractive alternative to paying the high fees of brokers and investment bankers. When independent sponsors bring growth plans and industry knowledge, some private equity firms are willing to share fees on busted deal fees.

In addition to selling a deal directly to a private equity firm, because so many independent sponsors have such a close connection to the investors in private equity, many are providing investment opportunities directly to limited partners. Limited partners have an appreciation for the lower cost structure of the independent sponsor, their flexibility on deal terms including management fees, not having their funds tied-up until a viable target is ready to close, and having a choice in whether a target is an attractive investment.

Family offices are also partnering more and more with independent sponsors, although family offices are also acting as independent sponsors. Since 2010, there has been a trend for family offices to allocate more dollars to private equity, but they are also taking an increasingly active role in their investments. Family offices differ from other investors; they may hold on to a company forever, and they are not quick to change the management of a company. Family offices also typically have some level of industry expertise in the industries that they invest in, particularly for first-generation family offices. They typically avoid auctions and like to close deals quickly. Family office investors tend to be open to making minority investments and are willing to leave control elsewhere, which makes them strong partners for an independent sponsor who intends to remain involved after closing. Because independent sponsors like to bring investors who can serve as operating partners and who will grow and professionalize the company, family offices are often the ideal investor for an independent sponsor. It is a reciprocal relationship, with the independent sponsor frequently staying involved, providing oversight and management, possibly through a role on the board.

Independent sponsors receive compensation for their services in a variety of ways: closing fees, management fees, stock awards, carried interest on equity investment of partner investor, and contributing an executed letter of intent to the investment vehicle as an in-kind contribution, in exchange for an equity interest. This latter source of compensation is particularly attractive to independent sponsors because it is considered by the IRS to be a tax-free contribution of appreciated property, and not subject to income tax. Many independent sponsors will roll their closing fees into the purchase price consideration to show the investors that they want an equity stake, and so that they have "skin in the game."

In 2016, the volume of deal-making finally slowed from 2015's record highs. The number one reason cited for the slowdown was the lack of quality targets for reasonable prices. This has been a growing trend for a number of years now. The results of this trend are that those who can identify quality targets are becomingly increasingly more valuable to M&A. Independent sponsors have the relationships and the assets to locate these deals, and we can expect that they will continue to be a growing force in the market.

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