MERGERS & ACQUISITIONS

Roundtable

Make Room for the Independent Sponsor

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Make Room for the Independent Sponsor

It's no secret that it has become more difficult for traditional private equity firms to raise captive funds. In fact, California Public Employees' Retirement System is looking to further reduce its number of private equity relationships by up to two-thirds. The harder fundraising environment, coupled with investment restraints and increased reporting requirements, has led more investment professionals to complete deals on a deal-by-deal basis as independent sponsors. The independent sponsors' efforts are making more of an impression on the deal business than ever before. Traditional private equity firms are working with independent sponsors to generate deal flow and traditional limited partners that more often want to invest directly into companies are also seeing the benefits of working with independent sponsors. Mergers & Acquisitions Magazine convened a special roundtable to discuss the benefits and challenges of working with independent sponsors. Benesch, Friedlander, Coplan & Aronoff LLP sponsored the event and the excerpted discussion that follows provides a range of perspectives from key players in the industry. Participants included traditional private equity investors, an investment banker, a fundless sponsor, a family office investor and a lawyer.

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James Hill, Benesch, Friedlander, Coplan & Aronoff LLP

Danielle Fugazy: How would you characterize the role independent sponsors are playing in today's market?

Jim Hill: Everybody is seeing more independent sponsors today than they did five years ago. Why is that? There are a number of talented managing directors coming out of private equity firms where they have not struggled with their investments necessarily, but the limited partners have made it more difficult for them to raise money and receive extra fees. Private equity funds are limited to a two percent fee structure and many fees they used to earn are offset by the two percent. If you are a $500 million fund, two percent is only $10 million dollars a year. A lot of experienced private equity professionals have moved away from their firms and decided to work with family offices to close deals.

Howard Romanow: It's been much harder to raise a fund since 2008, and some firms have wound down. All of those professionals in this very mature market have a ton of expertise that is now migrating into family offices or going independent. It used to be a family office would only be able to invest with a fund or a fund-of-funds, but that's not the case anymore. Many are tired of paying the fees charged by private equity firms for the returns they are

ROUNDTABLE PARTICIPANTS:

John Bartholdson, Juniper Investment Company

Baron Carlson, AEA Investors LP

John Fruehwirth, Rotunda Capital Partners

Danielle Fugazy, Mergers & Acquisitions

James Hill, Benesch, Friedlander, Coplan & Aronoff LLP

Howard Romanow, Island Management

David Solomon, Lazard Middle Market

providing and the incremental risk many are taking to try to generate carry. If you can do it yourself with your own team, you can downsize the risk and downsize the cost structure.

John Fruehwirth: It's substantially harder to raise a first-time fund. It's taking upwards of 18 months in some cases. There is clearly a bifurcation between funds that have performed and can raise capital in two to four months, and others that are taking two years. The regulatory environment has also changed. If you are now managing over $150 million dollars you've got to be SEC compliant, making it more costly to run a fund than it's ever been before.

Romanow: If you go back a bunch of years ago, you became an independent sponsor because you couldn't raise a fund. You were forced to do it, as opposed to you choosing to do it. Today more and more people are choosing to do it for the reasons laid out. It's almost as if they'd rather have the flexibility, control their own destiny, and not to have to deal with all this other stuff.

John Bartholdson: Attractive deals don't have trouble finding capital. An independent model can work extremely well for investors that can source attractive proprietary opportunities. Everybody who has lived through a lifecycle of one or more funds knows that your investment decisions are influenced and sometimes driven by fund considerations and therefore not optimized.

Baron Carlson: Ten years ago fundless sponsors had a negative connotation. The private equity community is recognizing that there are many independent sponsors out there that have had very good success in driving very high return deals. They are typically focused with a lot of depth and that's why a lot of private equity sponsors are looking at the independent sponsor community and saying, 'This is a good place to find deals.'

Fugazy: Do you think private equity firms are more interested in working with independent sponsors today then they have been in the past?

Fruehwirth: Absolutely. There are three or four independent sponsor conferences a year now. Three or four years ago there weren't any conferences. Many private equity firms are now proactively seeking out independent sponsors and trying to form long-term relationships. However, one interesting thing will be when the fund's LPs start asking questions like, 'How did you really source the deal? Why am I paying you two percent if the independent sponsor sourced the deal?' There will likely be fallout at some point.

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> Howard Romanow, Island Management

And you can be more selective, take longer-term deals, and it's a not a blind pool.

Bartholdson: Working with independents also lets larger limited partners invest in the lower middle market; they leverage off the skillset of the independent sponsor. Similar to co-investments they can do on the larger sized deals. But the only way for them to access the market is with somebody bringing them a deal, which an independent sponsor can do.

Fugazy: What are the economics of working with the independent sponsor?

Romanow: On one extreme it's a finder's fee. On the other extreme it's two and 20, or some version of that. It depends on what the sponsor brings to the table. What does the deal look like specifically? If it's an off market deal that's below market price, I'm much more inclined to pay a fuller fee. I don't really like two and 20 at all, but I'll do something that's much more structured if you get us a return on the deal. If we get a 3X deal, 4X deal or 5X deal then you can ramp up what the split is.

David Solomon: You have to look at what's a commodity and what's really value-added. Money is a commodity. On the other hand, the first thing an independent sponsor brings is deal sourcing. They might also have a strong personal relationship with the founder, which is really hard to build quickly, and you need that, so it's worth a lot. In addition, the independent sponsor might bring a particular vertical expertise that the money partner might not have. And then in the case of a family office, they may not have people in-house to process and do the underwriting, complete the diligence, and manage post-closing oversight, so there is a whole layer-cake of value, which then builds up to better economics. The more value the independent sponsor brings, the more economics.

Carlson: The economics differ depending on how much value the independent sponsor brings to the table. The more sophisticated independent sponsors have developed a roadmap for growth for targets and that's very valuable. That takes months, even years, to develop if you don't know that market. We take a very collaborative approach and try to work with independent sponsors as partners. And so our expectation is working very closely together with the board to try to grow a company. Typically, it's their relationship that they developed, and that's very valuable, you want them to be involved.

Solomon: And you might allow them some room in the carry, for example.

Carlson: Absolutely. You have to be reasonably generous with somebody that's developed a situation like that, because it's very valuable to find outstanding companies. We've found some real jewels with independent sponsors. We've had a lot of success working with sponsors, so we want to create economics where we're aligned very well.

Fruehwirth: We are seeing more and more sharing. If an independent sponsor can bring a proprietary deal to a fund and help grow it at above average market rates and expand the company's margins, the private equity fund will gladly split economics.

Hill: The key to being an independent sponsor working with a private equity firm is you have really good industry knowledge. The independent sponsor will actually have thought about how to grow the company, maybe through acquisitions or organic growth. That's a real value add versus just bringing in a deal. If you don't have a lot of knowledge of the industry, you're not going to get the same kind of compensation package.

Fugazy: How do you vet which independent sponsors you will work with?

Carlson: We're very open to working with any independent sponsor that has a good deal, but typically, we want to work with sponsors that have a growth mindset. It's important to have alignment up front so you know how are you going to work together. And it's also important that you have alignment on economics very early on. We try to develop deep relationships, and in some cases, spend the time to understand what we're mutually interested in. In many cases, we have pursued a thesis together early on and the relationship is not just forced via a deal.

Bartholdson: There is an added layer of making sure everyone is on board with the same investment plan. When you can find that alignment you have an advantage over a captive fund structure because you don't have the same worry about the size of the sponsor's investment, management and transaction fees and incentive waterfalls, for example. When you are starting with a blank sheet of paper, you can tailor the economics to achieve greater alignment.

Romanow: You really need to understand who the independent sponsor is, what motivates them, what their horizons are and how they think about things. If we're doing something beyond just the finder; if someone is going to be a partner with us in a deal, we're going to do an awful lot of diligence on them as well. Not necessarily look at their financials, but really figure out who they are, what they are about and how they act.

Fruehwirth: When we used to try to meet with family offices that were looking to invest in deals, they'd say, 'Don't waste my time until you have a deal.' Then you bring them a deal, they say, 'Well, I don't know you.' We now take this process: Give us 30 to 45 minutes to give you an overview of who we are. We don't have a deal to talk about right now, but we'd like to introduce ourselves, and we start building our credibility. It can take one to three years to build that trust.

Bartholdson: If you're scrambling to find capital to pull together a deal in weeks, you really are a finder, even though you may characterize yourself as an independent sponsor.

Fugazy: Is there enough room in the market for independent sponsors?

Carlson: Many independent sponsors today are ex-private equity professionals that didn't raise another fund. They realized there is a whole end of the market—many of which are family companies—that aren't really appropriate for an auction. It may be a family company that doesn't know what they could become, or they're not really interested in selling, but they hear a great pitch from an independent sponsor. The point is there are many situations that are under the radar and may have hidden value and independent sponsors identify them. And in that sense, it's a very healthy development, because it's grown the activity in the market. Independent sponsors are driving that growth.

Fruehwirth: We try to source deals directly. For example, there is a situation right now where it's a 73-year old founder of a business, price is secondary to legacy and how his employees will be treated. The founder said, 'I'm getting to know a couple of people over a few-year period and see how they want to approach my business, because this is a 50-year labor of love and I don't want to turn it over to the wrong hands.' That's a great situation for us.

Fugazy: How do sellers get comfortable with the independent seller and what does the process look like when there are independent sponsors involved?

Solomon: Running an auction, I'm uncomfortable with a two-headed equity monster, as we call it, because one of the partners can change their mind late into a process and blowup the deal. When I'm selecting the bidders who will make the smaller group of finalists, I have to be careful not to down-select to the wrong subset. If I believe that one group has higher risk, I will tend to swap them out for another bidder who could stay the course. But sometimes we don't run auctions if the client says, 'I want to find a great partner and we have that luxury of time.' And sometimes there is a hybrid auction, where we'll give a buyer with a ton of chemistry or expertise an early look and let them go a little further before we get into the auction.

Fruehwirth: We don't typically participate in auctions because it's an added layer of complexity. If a private equity firm like AEA is participating, they're doing diligence and trying to figure out the management team and we also have to raise the capital. It's that third ball up in the air that makes is difficult to complete. We try to seek businesses where Rotunda Capital is the first institutional investor and where we can potentially add more value. Many of our portfolio companies were founder owned before Rotunda invested.

Bartholdson: If it's an auction, it's an asset that's out there in the market. Maybe there is a unique industry angle you bring that makes it exciting for the investor, but it's not the ideal profile for marrying up an independent sponsor with the transaction.

Fugazy: How does an independent sponsor get the deal closed in a timely manner even if there isn't an auction?

Fruehwirth: We typically raise money from five to 10 different family offices in a given transaction so if one of them drops out at the last hour we still have a plan. We'll tell our partners, if it's done correctly, you're going to get allocated back. But I need to sit down with the banker and lay out: these are the

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families we're going to talk to; here's my date for soft circles, here is my date for hard circles, and one or two of them may want to come to see the company. We typically do that after the letter of intent.

Carlson: I've talked to some investment banks that have known a fundless sponsor is looking at a deal and doesn't have the capital, and then the fundless sponsor conducts this side auction, which makes people like David very uncomfortable, because they don't know what's going on.

Fruehwirth: Sell side advisors will often ask an independent sponsor: 'Are you going to take this to other private equity groups? Because if you are, just stop now, because you are going to somehow taint my M&A process.' The independent sponsor has to lay out again how they are going to raise capital and when they expect a response.

Romanow: We've actually had independent sponsors in process ask us to give a letter of support. If it's a deal we've seen and we believe in, great, but just to give a letter doesn't do any service.

Hill: We have acted as seller's counsel and the biggest worry is the independent sponsor takes a long time to raise the equity. You have to sort that out at the start.

Fugazy: How does today's environment impact the independent sponsors?

Solomon: There are always more people hunting deals than there are deals to buy; and depending who you talk to, there is $500 billion to $ 1 trillion of dry powder in committed funds. Because there is such an imbalance of money and opportunity, it always feels like there is a scarcity of deal flow. John, do you feel you see enough deal flow?

Fruehwirth: I actually do. There is a generational transfer happening; the boomers are getting older and getting ready to retire. The way we have to source, because we cannot participate in auctions typically, is that we've got to go down a deep entry vertical, create a thesis, rank out, find 50 to 100 companies and start building relationships with those companies by going to the industry conferences and networking. Often times it's not the companies that we had on that list that we end up acquiring, because it's a daisy chain two steps removed where we actually find the right deal, but it's a process.

Hill: I would say inventory is thin as to quality companies. Many private equity firms do not have individual business development guys or gals and they are just seeing books from investment bankers. The key to an independent sponsor is you find targets that are not being actively shopped and that provides huge value for the private equity firms.

Solomon: We tried to figure out how many private companies of interest are out there, how many are private equity owned, and how many public. We looked at U.S. census data from 2012. There are about 6.5 million companies in the United States. If you limit to those with more than 100 employees, the number drops to 102,000. So that's the relevant universe, of which seven percent are private equity-owned, that's up from two percent in 2000, and about five percent are public, that's down from seven percent in 2000. The family percentage is coming down from 92 percent in 2000, but it's still 88 percent of this group. It's the Holy Grail, which is where you guys are hunting. But it's a big, big deep pond. All my competitors are chasing the private equity divestitures of the world, because those are easy to find, they turn over every six years.

Fugazy: What do you think the future of the independent sponsor is and their credibility going forward?

Hill: Independent sponsors have a longer timeframe, but they have to make money, so they spend a lot of time courting relationships, which is very hard to do in a private equity firm when you really have to be buying. Independent sponsors really have to work hard to develop potential seller relationships and that takes a lot longer.

Carlson: More firms will start to try to institutionalize and we are seeing that happen now. I also think that more independent sponsors are going to pre wire their capital with a family office, or a private equity fund. Organizing themselves in that way will make them more competitive.

Fugazy: How difficult is it for independent sponsors to manage the expectations of investors?

Fruehwirth: It goes back to the relationship in terms of setting up the conversation the right way and what we are trying to achieve in this deal. For example, a lot of families may not be familiar with a distribution business or a logistics business so you need to be sure they understand the investment. And then communicating; we do semi-annual updates with all of our portfolio companies, we're always available for questions. Often times we talk to their tax advisors and give them updates on K-1's. We try to be very clear with what is going on at the company. We try to talk with our investors every 90 or 120 days just to say hello and give them updates.

Hill: Communications for private equity firms with limited partners has become much more demanding as well. They have to communicate a lot more often. When I was practicing law 20 years ago in Chicago, you would have an annual meeting, you would send out annual statements, but that doesn't happen anymore. You have to communicate a lot to keep the LPs happy.

Fruehwirth: We are also communicating to the sellers and bankers all the time, why am I relevant to a situation? What does our brand mean? When we say we're Rotunda Capital, what does it mean to the seller and what does it mean to the management teams that we have to work with both pre and post closing. What specialized industry knowledge do you bring and how are you going to make a difference to that firm on a long-term basis.

Solomon: And the problem you're finding is there are a lot independent sponsors out there that don't have the credibility and haven't really developed the professionalism of their efforts, and so you're painted with a broad brush sometimes.

Fruehwirth: Absolutely. It goes back to taking a couple of years of building the important relationships. I have to prove to everyone I am going to do what I say I am going to do. And at some point everyone says, 'These guys seem to do what they say they are going to do.' We also raise capital on a city-by-city basis, which helps when investors start their reference checks on Rotunda and the partners.

Carlson: Early matchmaking and driving the deeper relationships between the private equity firms and the independent sponsors is where things need to go. So you're seeing private equity firms proactively invest time with independent sponsors around an industry thesis. It's better for the independent sponsor and it's better for us, because then we have the time to get to know the market more. We've fallen down on a couple of cases as we had an independent sponsor come to us, show us a deal, and then it's a high speed process: they want to sign the agreement in three weeks. It makes us very uncomfortable.

Bartholdson: The relationship between the parties and their respective ownership and capabilities matter. At one end of the spectrum it's a direct investment, where a single or small group of investors are the owner and the sponsor is the hired manager and at the other end the sponsor is the lead investor and has brought in like-minded partners. So having alignment with where you want to take the company, as well as what roles you and your investors will undertake become even more crucial.

Fugazy: How does the independent sponsor create value?

Solomon: Sector expertise is going to matter more and more, because as money becomes more commoditized, a sponsor's real value comes from what they do after buying the company in terms of operational improvements. Investors need to quickly understand the growth opportunities in that industry. So, for example, John, the more you can bring a logistics sector focus, the more value you bring, because it's really about the vision for the holding period of five years or longer. You can't just buy companies and expect financial engineering to do the trick.

Hill: Private equity firms focus on certain industries and there are many independent sponsors - be they one or a team - that match up with the PE firms focus. But, PE firms, many of them, are not doing their homework to match up an independent sponsor with their industry focuses and they need to do that right away. They need to work hard at matching up with the right independent sponsor.

Fruehwirth: We've got playbooks that we've built around three verticals. What know the levers that create value within those three industries and then if we need outside consultants or people we will bring them into the portfolio company. We believe the core drivers at every company are the people, process and technology. We try to help each portfolio company address those three core drivers.

Hill: It's really about developing the relationship with the independent sponsor. The independent sponsor needs to be somewhat deep, have a good track record and understand the industries. Being generic just doesn't really work.

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> Baron Carlson, AEA Investors LP

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