Why Sponsors Matter

The Lead Left - A Special Report

Beginning in September 2016 The Lead Left published a series of articles on sponsors. This report consolidates those articles.

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Introduction

Our discussion of the Fed's confusing position on interest rates drew a number of favorable comments. "This is precisely right," one reader wrote us. "They should just go ahead and raise rates. The more they delay, the tougher it'll get."

But our reference to the economy as a "Goldilocks environment" left at least one reader puzzled. "Loved your article," this young banker tweeted us, "but was wondering what the state of the US economy has to do with the Three Little Pigs?"

Nursery rhyme confusion seems to be just one of the many symptoms afflicting investors today. Amid numerous cross-signals from both the Fed and the economy, it's a wonder anyone retains a clear sense of direction.

Bullish signals from governors following their August meeting resulted in the "Jackson Hole rally" in which markets headed higher. But worries about interest rates, oil prices, and corporate earnings have caused the Dow to sink 500 points in the past week.

This bewildering state of affairs reminded us that investors now put a premium on non-correlated assets. They also crave access to leadership that understands how to operate in an environment in which market volatility will be a long-term factor.

That view has inspired us to address a topic that seems to be much on the minds of institutional investors; namely, what are the benefits of investing in private equity owned middle market companies, compared with non-sponsored, mid-corporates?

In this special report, we'll examine the features of both types of lending, with particular attention to the role private equity sponsors play in the management and governance of their investments. We'll also take a look at the non-sponsored lending landscape – who are the players, what are the upsides, and what are the risks?

To begin, let's state the obvious: private equity sponsors are professional investors/managers whose job it is to invest their capital (and that of LPs) to produce the consistently highest returns at the lowest risk. As we've often highlighted in this space, PE-backed companies are chosen because they represent the best opportunities for revenues and earnings growth, as well as enhancement of enterprise value.

Middle market companies are often begun by entrepreneurs with visions of fulfilling a consumer or corporate need. These founders can be long on creativity and short on management skills. Their businesses display early growth, then plateau unless more experienced executives are recruited to help guide corporate development.

About The Lead Left

The Lead Left reviews deals and trends in the capital markets with a unique focus on the mid-market space and is read by thousands of influential industry participants.

- Original commentary backed by thirty years of capital markets experience
- Weekly interviews with top decision makers in banking, private equity, and credit investing
- Data and commentary from four of the leading global capital market research firms
- Detailed information on deals in the market
- Plus our popular Charts and Quotes of the Week

More about us

About Churchill Asset Management

Churchill Asset Management LLC, affiliated with TIAA-CREF, originates, underwrites and manages senior and unitranche debt financings to middle market companies, primarily those owned by leading private equity firms.

We are a highly experienced lender with a successful record of investing over business cycles. Our team has funded $4.3 billion of middle market senior loans in over 400 transactions with over 100 private equity sponsors.

Benefits to a Churchill Relationship:

- Reliable partner for sponsors and lenders
- One-stop capability across the capital structure
- Senior partners involved in all aspects of deal process

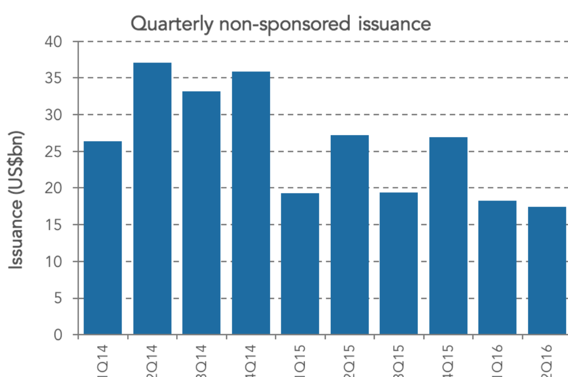
Churchill Asset Management LLC – Let us partner with you

More about us

It's for precisely that reason that lending to mid-corporates is tricky. Without better managers, these companies find it difficult to "get to the next level," and may run into trouble in challenging economic or industry climates. Ironically, these are the very companies sponsors look to invest in. And they bring unique tools to the table.

Off Season

Second quarter non-sponsored loan volume was down 5% from the first quarter but off sharply from the second quarter last year.



Sources: Thomson Reuters LPC

Enhancing Corporate Value

Let's turn to how private equity sponsors can help accomplish these goals. The first thing these firms look for is a partner. "There's a common myth that we buy companies to take them over and manage them," one managing partner of a New England middle market firm told us. "We buy them so that the management team can manage them."

He went on. "What we do is give the team the tools to grow. For example, many of these businesses don't have the access to capital they need to finance their growth. In many cases, they don't even have the experience or sophistication at the financial management level to know what's available out there. We can help with that."

Our own experience as a lender reinforces this point. CFOs of smaller companies tend to be more in the mold of treasurers or controllers. But given the increased demands of a PE-owned company taking on leverage, the skill sets required for the position are more akin to public companies. Knowing this, debt providers make credit decisions based on the strength of financial management. A weak presentation by a CFO at a lender meeting can do more damage to credibility than one by the CEO.

Another theme is distribution. How do you get your product to market?

A portfolio company we know had a fast growth skin-care line with excellent penetration in health food stores, but couldn't get into the bigger retailers. "I had been trying for years to break into CVS," the founder told us, "but it wasn't until the buyout when our [sponsor] partners helped crack the code." She continued. "They had been successful with several other launches, so brought the experience with the retailers we didn't have."

This is particularly true for middle market companies who look to expand overseas. By their nature, smaller companies lack the resources and capabilities to leverage partnerships with international vendors. But PE firms with global reach can tap their connections to pave the way to build these relationships. Or buy

them.

We'll cover add-ons in future reports, but helping companies execute an effective M&A strategy is one of the hallmarks of a good sponsor. Being able to successfully identify, finance, and integrate acquisitions can make or break your returns and growth plan.

Corporate development help comes naturally to sponsors employing operating partner models. These former Fortune 100-quality executives, whether as on-the-ground consultants or replacing management, give less seasoned teams access to decades of experience in working through complex growth or cost streamlining projects.

Working with Family-owned Companies

We examine next what motivates a family-run, privately-held, or even public company to sell to a private equity firm.

On the face of it, it would seem challenging to convince businesses owned by families for decades to give up control to an outside group. And private equity as an industry has not always had the best public relations. Yet the reality is quite different. For many reasons, sellers have looked increasingly to private equity to solve a variety of issues.

The most obvious is generational wealth transfer. There's a huge wave of baby boomer founders of small to medium-size companies who are heading to retirement. One study reported almost one-quarter of all entrepreneurs are over age 55. These patriarchs/matriarchs don't always have younger relatives interested in taking the reins of the family business.

There's also the problem of multiple generations with varied interests. We've seen many situations where one family member wants to keep the company, while the rest want to take monetize their share and pursue other interests. The remaining relative may not have the liquidity to buy out the rest of the family.

That's where sponsors come in. By investing significant capital, PE can give exiting families the liquidity they seek, yet still retain the interested member with a minority share of the equity, a board seat, and a C-level position on the management team.

As we noted above, sponsors are able to provide both financing and expertise to take the company to the next level of growth. In those cases, the business can become exponentially more valuable to the family than if it had been held or sold outright. A smaller slice of a much bigger pie can be worth more than the original pie.

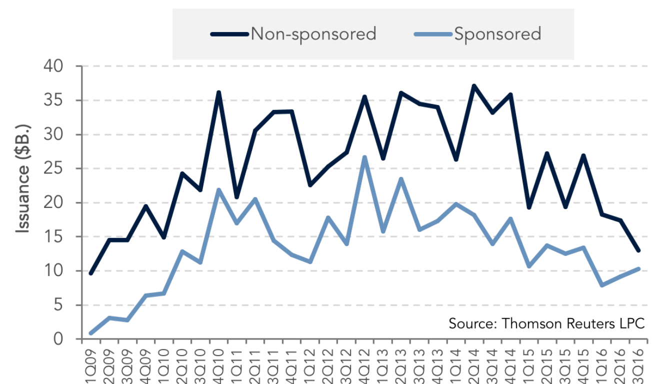
Another benefit to selling founders is the sales process itself. Large corporate buyers may be able to offer a higher purchase price at auction. But their integration plans often involve cost cutting and layoffs, rather than growth-oriented strategies. Sponsors have more flexibility integrating founders into future organizational plans.

Indeed, retaining key family personnel is a top PE priority with new buyouts. This is particularly true where continuity is critical, such as maintaining client relationships. In those cases family retention is viewed favorably by both the sponsor and lenders to the company.

Finally, sponsors understand that the auction process itself presents challenges. While it is designed to achieve the optimal price for the selling family, sometimes entrepreneurs recognize certain firms may be a better fit, despite a lower offer. Built-in incentives can help sweeten the overall pot.

Slow Flow

Loan volume for both sponsored and non-sponsored middle market transactions have generally slumped since 2014.



Sources: Thomson Reuters LPC

Non-Sponsored Lending Revealed

Given all the benefits of having a private equity firm as your partner, why would you even finance a company without one? We put that question to Brett Hickey, the CEO of Star Mountain Capital, who specializes in this sector.

"There's a lot of hype around non-sponsored transactions," he told us. "It's definitely buyer beware. If you're a lender to these companies, there are many considerations you should keep in mind:

"First, do you have the expertise to do the additional due diligence to assess the operational, industry, management, legal and other risk-reward aspects of the company without the benefit of an experienced private equity sponsor?

"Second, do you have the operational resources to help develop or replace the management team, if necessary?

"Next, do the current owners have additional capital to support the company if it faces challenges? If not, does your firm?

"Does the borrower have the financial sophistication to execute its business plan? If you're financing an acquisition, has the management ever made executed one? No matter the size, these require meaningful integration planning and management.

"Finally, is the exit strategy for your loan aligned with the business owners' plan?"

But can you get compensated enough, we wondered, for all this extra work and risk?

"Investors focus on the fact that leverage multiples are lower, financial covenants tighter, and spreads higher," Brett said. "But for those higher rates to materialize, you need much stronger underwriting and ongoing portfolio management capabilities."

Another top debt manager who invests in non-sponsored loans agrees. "Does the management team have a history of handling leverage and behaving properly when issues arise?" he said. "The stories may be simpler than sponsored deals, but you have to check more operational boxes. For example, is the back-office institutional?"

One senior portfolio manager with significant non-sponsored experience said sector focus was critical. "We prefer companies that don't face secular headwinds. If you're investing at the top of the capital stack, unless it's an over-leveraged cyclical, you should get paid back. But the "Five C's of Credit" are even more a focus than usual."

Finally, another CEO of a leading direct lender to non-sponsored corporates zoomed in on liquidity as his top concern. "Because there's no sponsor with deep pockets to provide a liquidity safety net, we want to ensure that the borrower has sufficient capacity to carry it through any cash crunches. We track working capital like a hawk!"

Non-traditional Sponsors

There's a third category of owners that don't get much attention, and growing in importance.

So-called "fundless" sponsors – also called independent, or non-traditional sponsors – act as a hybrid of three parties. They combine the deal sourcing of investment bankers with the targeted allocation of capital by limited partners, and the expertise of GPs who perform a multitude of functions designed to enhance business performance.

As "fundless" implies, this class of owners does not rely on large vehicles raised from LPs designed to invest in a number of platforms over several years. Instead, independent sponsors round up investors on a deal-by-deal basis. They also invest personal dollars into the company for a significant equity share – often 20%.

The obvious risk for lenders is that independent sponsors do not have the reserve capital already allocated within a large fund for additional investments. This becomes vital in turnaround situations. Also, because the ownership of these companies is often split among a number of

LPs, corporate governance can be a challenge.

And as one experienced lender told us recently, not all independent sponsors are created equally. Some have decades of experience successfully managing businesses across a broad range of industries. Others do not. Lenders must focus their due diligence on the track record of the sponsor as well as on the borrower.

Similarly not all "sponsored lending" is the same. This point was made to us by a top CEO of a leading middle market firm who has read our series with interest.

"Sponsored lending is a very different dynamic in the middle market compared with the broadly syndicated market," he told us. "We are 'buy and hold' investors, so arrangers need to bring all the lenders along. Our investment approach governs."

"In the broadly syndicated world, the reverse is the case. The large, liquid, trading-centric market emphasizes successful distribution. It's a sell-side model versus a buy-side one."

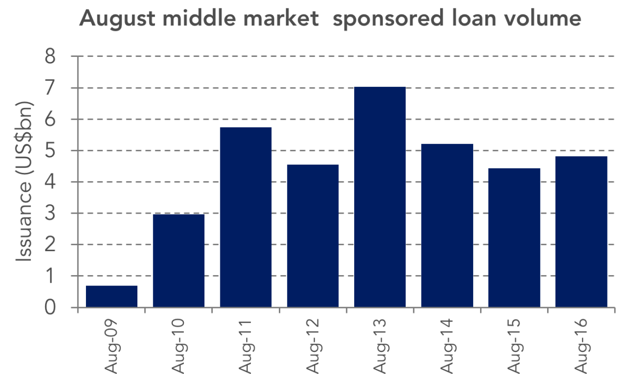
But isn't bank regulation slowing that down, we wondered?

"Leveraged Lending Guidance has helped," he said. "But it's still a sellers' market for syndicated loans. Sponsors are still paying significant underwriting fees. From a fiduciary perspective, sponsors need to make sure they are getting as much value as they can."

"There's plenty of fund appetite out there right now. Even for close to 7x leverage cov-lite deals. Because the large bank arrangers aren't holding much paper, they're not as sensitive as middle market arrangers. In our clubby world, 'buy-and-hold' lenders have more leverage and incentive to draw the line when things get frothy."

Summer Slump

While last month's loan volume seemed exceptionally slow, it was actually better than 2015's level, and consistent with the past five years.



Sources: Thomson Reuters LPC

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