Independent Sponsors Gain Acceptance

Danielle Fugazy | September 24, 2019

Independent sponsors accounted for about a quarter of the more than 5,000 private equity deals completed in 2018, according to Crain's New York. An estimated 250 independent sponsors operate in the private equity ecosystem today — a number that continues to grow.

And yet independent sponsors are still treated by some bankers as the redheaded stepchild to traditional private equity firms. "The number of independent sponsors in the market has skyrocketed in the last three years. There are conferences focused on independent sponsors and advisory shops now willing to work with them more or even exclusively. Five years ago, you didn't see this. However, they still have an uphill battle," says Pratik Patel, a principal with Freedom 3 Capital. "Sell-side advisors will not push to work with an independent sponsor if traditional private equity with dedicated funds or corporate buyers have interest, all else being equal."

It's true that independent sponsors may take longer to shore up deal financing and may not have a huge team to diligence team. But their model also comes with upsides, and given their prevalence in the market today, excluding them does a huge disservice to the entire industry.

Independent Sponsors Have A Diverse Pipeline

Independent sponsors have a unique network. Many times, independent sponsors have a deal pipeline that typical private equity investors wouldn't have. "Independent sponsors often traffic in deals and then sometimes look for a private equity firm to partner with. This can turn into a great opportunity," says Patel.

According to a 2019 report by accounting firm Citrin Cooperman, almost 75 percent of independent sponsors' deal flow comes from business brokers, while 39 percent find their deals from company owners and management and just about the same percentage find their deals from operating executives and service providers, such as accountants and attorneys.

"Investment banks have a list of likely private equity firms and strategic acquirers to whom they will go out. But independent sponsors also have extensive networks of potential buyers that bankers may miss out on if they do not include independent sponsors in their process," says Richard Baum, the managing partner of Consumer Growth Partners, an independent sponsor focused exclusively on retail and branded consumer products companies.

Independent Sponsors Can Be Creative

With no real investment mandates, independent sponsors have the flexibility to set terms that make sense for sellers. According to the Citrin report, almost 60 percent of respondents became independent sponsors because they value the flexibility the model provides. "Sometimes independent sponsors win deals because they are more creative with how they can structure the transaction. Management can roll over, they may pay upfront, or they may take a seller's note. They don't have the same mandates that private equity firms have," says Patel.

John Hill, a co-founder of JW Hill Capital, an independent sponsor, agrees."The model supports tremendous flexibility in deal and capital structure thereby allowing us to consider a broad range of opportunities. In this current market, a well-constructed deal will generate significant interest from various capital partners, resulting in optionality on how to capitalize the deal," says Hill, adding that his firm is also creative with how they work with a company. "We focus on the needs of the business and the objectives of the seller to develop an investment thesis that makes sense for all parties. Given our operating experience and industry expertise, we are generally open to special situations where we see a clear path to transformational value creation."

Independent Sponsors Have Industry Expertise

Many independent sponsors became independent sponsors because they created wealth in an industry and believe they can grow their wealth by investing in the industries where they have expertise. Fifty percent of independent sponsors came from C-level management jobs prior to become independent sponsors, according to the Citrin report.

Hill and his partner are former operators who have worked at venerable firms like Honeywell, Rockwell Collins, and Verdiam. The partners focus on finding deals in the industrials, aerospace, defense, nuclear, energy, medical device, and electronics space—sectors where they have strong operating expertise. "We look acquire corporate divestitures or privately held companies looking for their first institutional capital and a growth partner. As former operators, we look for deals that fit the skills and experience of us and our extended network," says Hill. "Our industry and operating experience often enables us to quickly develop rapport with the seller—particularly a seller who highly values legacy and a future for the employees."

Consumer Growth Partners' Baum says many times the independent sponsor may have a previous relationship with the CEO or management team through industry or personal contacts. "This personal connection can put the independent sponsor in the pole position with the seller and allow them to really gain the company's trust," says Baum.

Independent Sponsors Offer Institutional Investors More Optionality

Hill argues that the independent sponsor model offers the LP several potential benefits over a traditional committed fund. "The independent sponsors gives LPs several advantages, including deal optionality, access to quality deals in a less efficient market, and transparency. By aligning with a small, specialized sponsor, with deep experience in a particular vertical, they also increase the likelihood of outperforming the market."

Independent Sponsors Are Entering the Mainstream

Although the market still hasn't completely accepted the independent sponsor model, many consider independent sponsors to be more mainstream. "Independent sponsors are now a very credible source of capital. We even have a better name. Previously we were known as 'fundless' sponsors, and now we are at least 'independent,' which sounds a whole lot better. The biggest challenge facing independent sponsors is still the certainty of raising capital, but independent sponsors often have an investment or expertise angle that private equity firms may not have, and the industry is recognizing that," says Baum.