GUIDE TO

INDEPENDENT SPONSORS

2ND EDITION

From the editors of
Buyouts, VCJ, Active LPs
and The PE Hub Network

Buyouts Insider

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EXECUTIVE SUMMARY

INDEPENDENT SPONSORS ON THE RISE

BY PATRICK MULHOLLAND

Some private equity professionals believe that independent sponsors—private equity firms that operate on a deal by deal basis—don't operate that way by choice. If they could raise a blind-pool fund, they would.

But if that was ever true, it's certainly not true today. Our survey of independent sponsors, conducted in February and March of 2019, reveals that just over half (51 percent) have no intention of going on to raise a fund.

Perhaps it's due to a wave of new firms in the market. According to research conducted by **Citrin Cooperman**, an accountancy and business advisory firm, out of a sample size of 245 firms, just under half of all independent sponsors surveyed (46 percent) were established between 2013-2018.

Whatever the reason, firms are sticking to the independent sponsor model, championing what they see as its superior deal economics and investment ethos.

"THERE'S A HUGE AMOUNT OF LIQUIDITY IN THE MARKETPLACE TODAY."

—Howard Gurvitch, Gurvitch Family Office

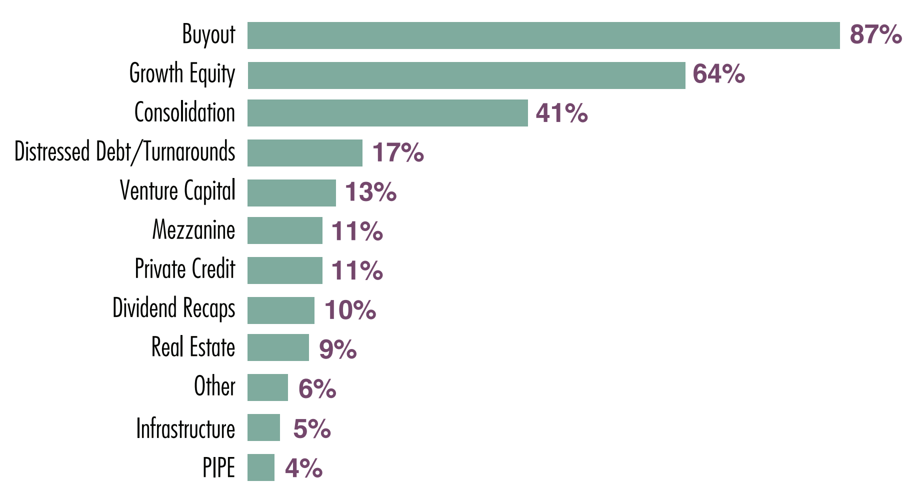
"We've always operated this way," said **David Mann**, a partner at **Firefly Group**, an Indianapolis-based independent sponsor that was founded in 2014. "We're not doing this because we can't raise a fund," he added. "We're proactively doing this because we believe it's the best way to do business."

In recent years, there has been a growing acceptance of independent sponsors among investment bankers, family offices, and other capital providers.

"If they have a deal, it doesn't matter if they're a funded sponsor or a fundless sponsor," said **Ryan McGovern**, managing director at capital provider **Star Mountain Capital**. "What matters is their ability to get the deal done."

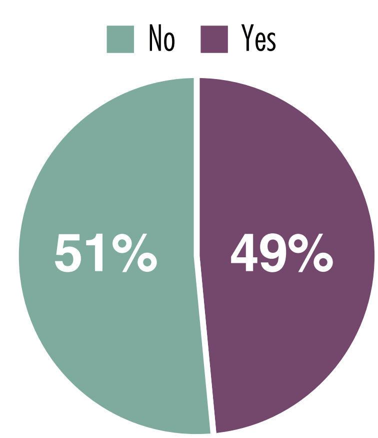
Christian Albert, managing partner at funds-of-funds manager **Bowside Capital**, has also seen the market "shift dramatically" from a position

INVESTMENT STRATEGIES
(RESPONDENTS COULD PICK MORE THAN ONE)



Source: 214 Independent Sponsors

DO YOU PLAN TO RAISE A COMMITTED FUND?



Source: 214 Independent Sponsors

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"THEY KNEW WE WERE ABLE TO PUT TOGETHER A SUITABLE CAPITAL STRUCTURE AND BECOME A LONG-TERM HOLDER."

—Drew McCuiston, Firefly Group

in which the investment community shied away from managers without a pool of capital to draw from. In fact, he sees independent sponsors as an important component of his firm's business strategy.

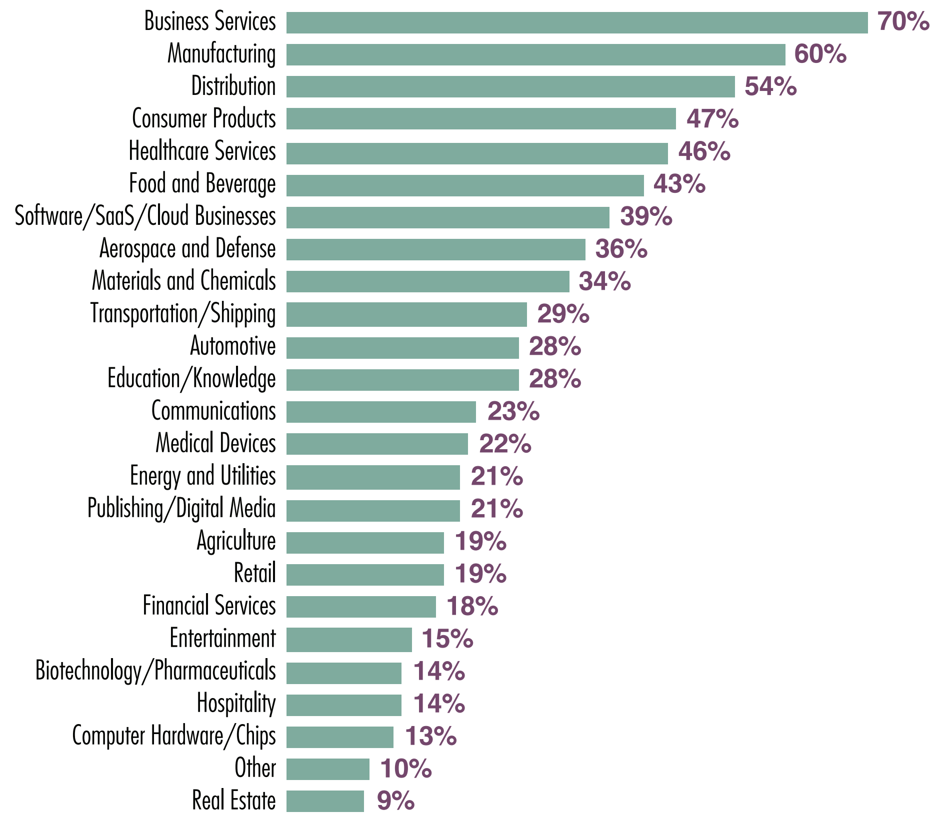
ECONOMICS

The change in fortunes for independent sponsors is no happy accident. Alongside grit and determination in competitive deal-sourcing, independent sponsors have skillfully turned market conditions and regulatory hurdles for private equity to their advantage.

"It's all [about] deal economics and control," said **Sylvie Gadant**, a partner at Citrin Cooperman and the author of their *2017 Independent Sponsors Report*. The main capital providers to independent sponsors tend to be family offices. These firms offer more money and control than other sources of deal flow because they do not usually have a business development officer seeking out transactions. Instead, they look to independent sponsors to pick out good deals on their behalf.

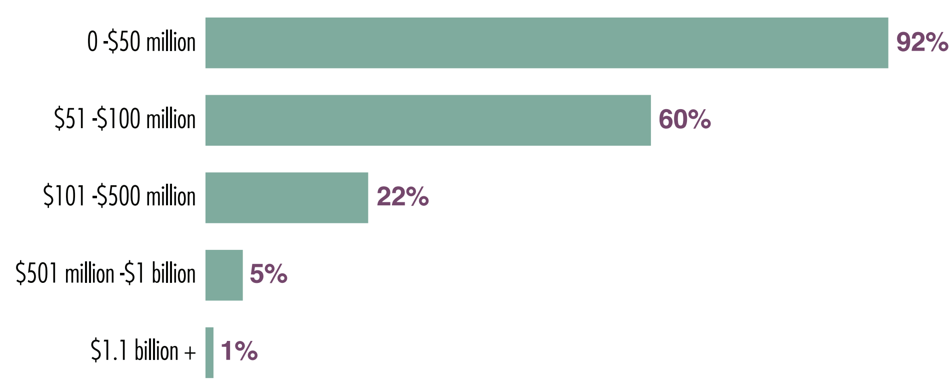
Steven Abernathy, principal at **The Abernathy Group II**, said that it was much easier for family offices like his to focus on one or two companies at a time as opposed to committing for a set number of years to a broader pool of investments, especially toward the end of the market cycle.

INDUSTRIES TARGETED
(RESPONDENTS COULD PICK MORE THAN ONE)



Source: 214 Independent Sponsors

ENTERPRISE VALUE, TARGET COMPANIES
(RESPONDENTS COULD PICK MORE THAN ONE)



Source: 214 Independent Sponsors

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"IT'S ALL [ABOUT] DEAL ECONOMICS AND CONTROL,"

—Sylvie Gadant, Citrin Cooperman

In addition, independent sponsors offer lower management fees than managers of dedicated funds.

"Unlike the classic two and twenty model, we don't have a two, because we don't have a fund," said Ben Procter, a partner at independent sponsor **Watermill Group**, though he admitted the carried interest is somewhat higher. "We charge our management fee to the company up front. They pay us a certain amount on a monthly basis, which then funds our operation."

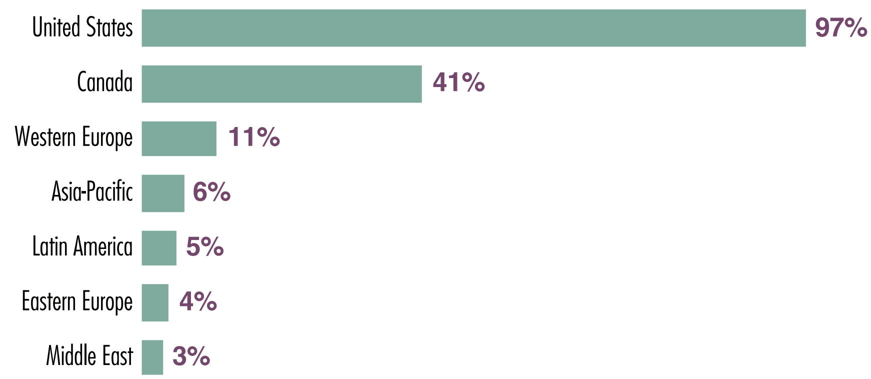
Independent sponsors also have a competitive advantage in that they cover broken deal costs. This is an attractive proposition for family offices, but it can come as a challenge for independent sponsors. Given that independent sponsors rely on receiving a cut of the profits in a given transaction, to get paid, they simply must close the deal.

Another catalyst for the growth of the independent sponsor model, according to Albert, has been the regulatory constraints placed upon the private equity industry after the 2007/08 financial crisis. These disproportionately affected funds.

But now, the current administration's tax reform package looks set to generate a windfall in private equity markets. A reduction in the rate of corporate tax from a 35 percent maximum tax to a 21 percent flat tax, as well as an increased remit for tax write-offs, and a three-year holding period to qualify for the long-term capital gains rate treatment, will help stimulate activity.

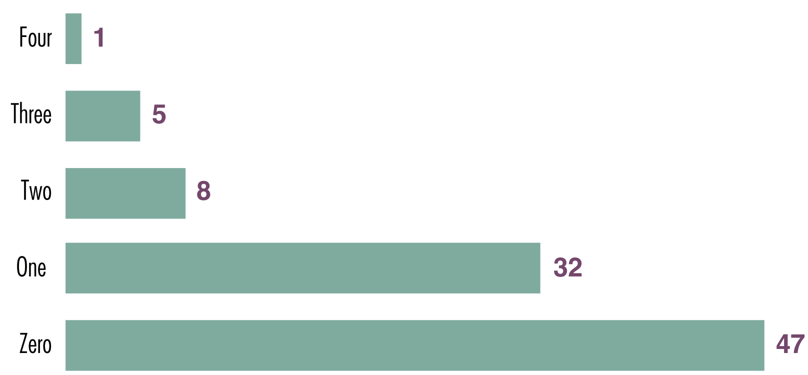
Reputation is everything for independent sponsors. They live and

WHICH REGION(S) DO YOU TARGET?
(RESPONDENTS COULD PICK MORE THAN ONE)



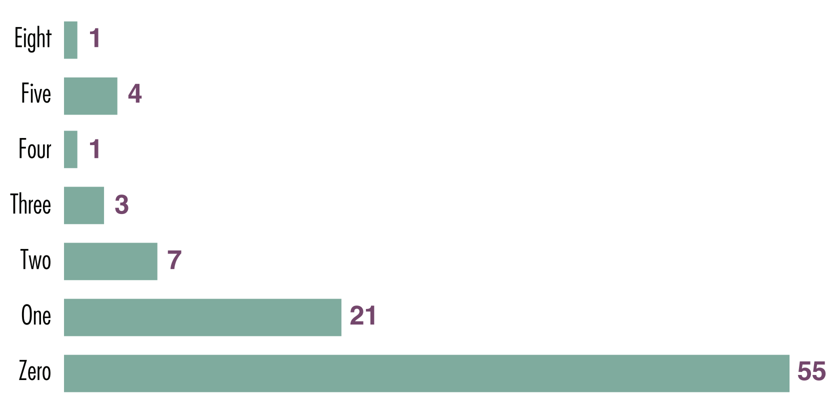
Source: 214 Independent Sponsors

HOW MANY PLATFORM COMPANIES DID YOUR FIRM ACQUIRE IN 2018?



Source: 93 Independent Sponsors

HOW MANY ADD-ON ACQUISITIONS DID YOUR FIRM MAKE IN 2018?



Source: 93 Independent Sponsors

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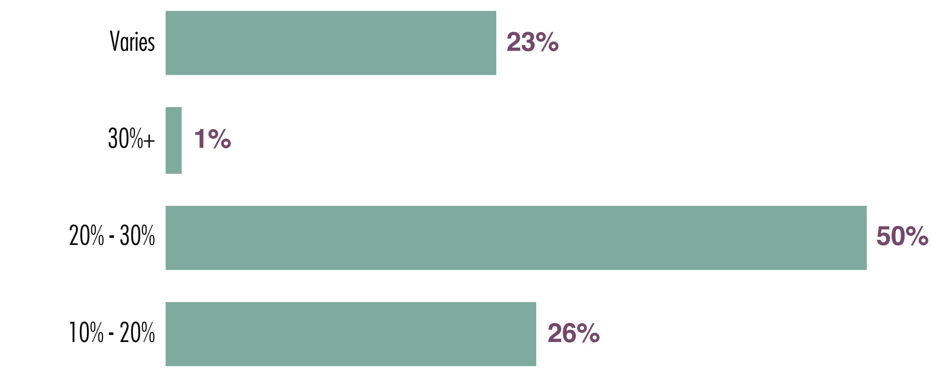
“WHAT MATTERS IS THEIR ABILITY TO GET THE DEAL DONE.”

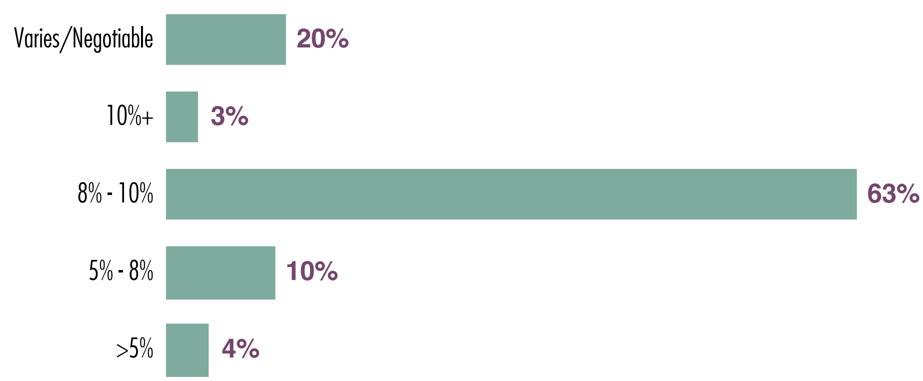
—Ryan McGovern,
Star Mountain

WHAT CARRIED INTEREST DO YOU CHARGE?
(STARTING RATE)



Source: 103 Independent Sponsors

WHAT IS THE HURDLE RATE BEFORE YOU CAN TAKE CARRIED INTEREST?
(STARTING RATE)



Source: 97 Independent Sponsors

die by their ability to forge long-lasting business relationships with their clients.

“You ought to have worked with them before and gotten to know them on a professional basis before investing,” said Abernathy.

MARKET CHARACTERISTICS

There is no such thing as an ‘archetypical independent sponsor.’ Firms differ by a range of factors, from deal structure and sector focus to the firm’s key target companies and the size of its active portfolio.

What independent sponsors hold in common, according to our survey, is an appetite for deals in the lower middle market and a willingness to take on co-investors. Around 92 percent of firms surveyed target companies worth up to $50 million, while about 60 percent reported they would pursue transactions worth between $51 to $100 million (respondents could pick more than one desired target range).

Howard Gurvitch, chief investment officer at **Gurvitch Family Office**, has a clear idea of what makes for a great independent sponsor opportunity, and it “can’t be just another run-of-the-mill private equity transaction.” Gurvitch looks for opportunistic, off-the-beaten-track, bespoke transactions that offer something unique, something that cannot easily be achieved with a fund.

Founded in 1978, Watermill Group is a well-established independent sponsor based out of Lexington, Massachusetts. Procter has been sponsoring what he calls “value industrial deals” for over thirty years, since 1987.

“Value industrial deals are businesses that have some sort of story about them,” said Procter. Typically, these include out-of-favor industries, management transition issues, deal process checks, or pension plan issues.

In August 2017 Watermill acquired **Cooper & Turner**, a British family-owned business that has been at the forefront of structural bolting manufacturing for more than 160 years. The Sheffield-based company, owned by two brothers, wanted to buy out a minority partner and enlisted the services of Watermill to see a smooth transition in its management structure.

Over at independent sponsor Firefly Group, the partners saw that few firms were investing in $1 million EBITDA companies in the Midwest, and seized the opportunity. They enjoy the “hands-on approach” of partnering with companies and being a strong presence in the day-to-day running of their businesses.

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In the summer of 2018, *Buyouts* reported that Firefly Group had acquired **EOS Worldwide**, a leading provider of systemized concepts, tools, and training that help entrepreneurs get the most from their businesses.

Drew McCuiston, another partner at Firefly Group, said that EOS's founders, **Gino Wickman** and **Don Tinney**, were encouraged to do the deal because they felt that Firefly would "take a long view" of its potential.

"They knew we were able to put together a suitable capital structure and become a long-term holder," said McCuiston, who is not opposed to hanging on to a company for ten years to see the job through.

Our survey showed that roughly 75 percent of respondents had a staff count of five or less, which means that investors are placing faith in the resolve of small, but effective, teams to get the job done. For example, Firefly Group has four employees

"WE'RE NOT DOING THIS BECAUSE WE CAN'T RAISE A FUND. WE'RE PROACTIVELY DOING THIS BECAUSE WE BELIEVE IT'S THE BEST WAY TO DO BUSINESS."

—David Mann, Firefly Group

on their payroll, but together, they have decades of business experience from both a financial and operational standpoint. Two of their partners previously worked for family offices. One was a venture capitalist, and another was an investment banker and management consultant.

"There's a huge amount of liquidity in the marketplace today," said Gurvitch, "but if you're not somebody who has a reputation in private equity circles, it is still a burden to raise capital while committing to build a deal."

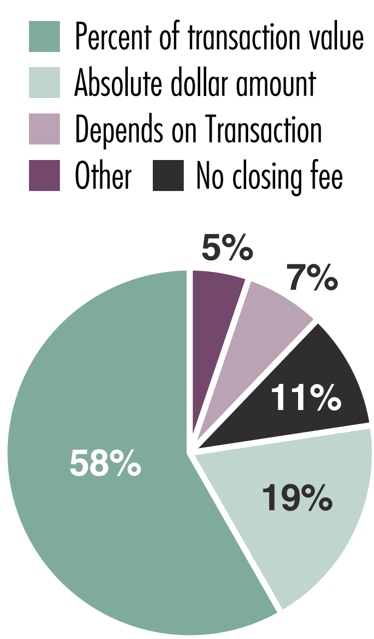
The structure of a fund allows for an alignment of interests between the independent sponsor and its capital providers. Similarly, whereas funds have the benefit of 'hedging their bets' across several companies, independent sponsors are on the hook for a lot of money if they have done a couple of bad deals.

For these reasons, the most successful independent sponsors work with repeat capital providers. Watermill has 75 long-standing clients, and more than half of them come into every new deal the firm makes. Firefly Group's recently completed EOS deal required capital from **New Canaan Funding**, with whom a partner at the firm, **Mark Sneider**, had a relationship that was more than a decade in the making.

With so much at stake, being an independent sponsor is not for the faint of heart. The road to building a successful practice is as challenging and tough as it is exciting and rewarding. Gadant of Citrin Cooperman warns new entrants to the market that they should think ahead. If they want to succeed, they will have to save up and prepare for a "two-year runway" when they will have to pay out of pocket for the costs of running their offices while waiting for their management fees to rise to a self-sustaining level.

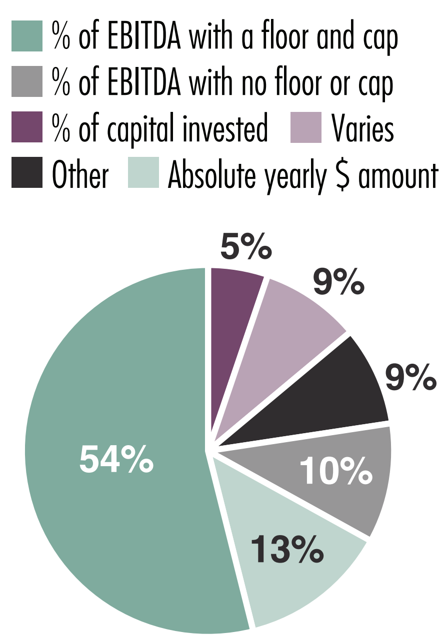
Firefly Group's Mann agrees. The need to be able to go two years without compensation is the first of five pieces of advice he gives to new independent sponsors that are just starting out. The others are: have a quantifiable value you can bring to an opportunity, be in the know of business opportunities, bring your own capital to a project, and be able to find a proprietary investment.

HOW DO YOU CALCULATE YOUR CLOSING FEE?



Source: 115 Independent Sponsors

HOW DO YOU CALCULATE YOUR MANAGEMENT FEE?



Source: 115 Independent Sponsors

GUIDE TO INDEPENDENT SPONSORS

2ND EDITION

Sample Entry from **Guide to Independent Sponsors, 2nd Edition**

AGI PARTNERS, LLC

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New York, NY 10016
Phone: 646-220-4096
https://www.agi-llc.com/

KEY INVESTMENT PROFESSIONALS

David Acharya, Partner
dacharya@agi-llc.com
New York, NY

OVERVIEW/INVESTMENT STRATEGY

AGI is a lower-middle-market buyout firm that focuses on controlled positions in business and marketing services and TMT companies.

YEAR FOUNDED: 2011

STAFF WORLDWIDE: 5

ASSETS UNDER MANAGEMENT: $40 million

PORTFOLIO COMPANIES: 2

INVESTMENT STRATEGIES OF INTEREST:

- Buyout
- Growth Equity
- Consolidation
- Private Credit
- Mezzanine
- Dividend Recaps

TARGET INDUSTRIES:

- Business Services
- Communications
- Publishing/Digital Media
- Software/SaaS/Cloud Businesses

ENTERPRISE VALUE OF TARGET COMPANIES:

- 0 - $50 million

TARGET REGIONS:

- United States
- Canada

ARE YOU ACTIVELY SEEKING INVESTMENTS? Yes

WILL YOU SEEK NEW CO-INVESTORS? Yes

DO YOU HAVE PLANS TO RAISE A COMMITTED FUND AT SOME POINT? Yes