It's Just Math – Independent Sponsor Transaction Survey

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As the first half of 2018 continues to show a white-hot M&A environment, the prevalence of independent sponsor activity remains a consistent theme. To provide greater visibility into the "market" for independent sponsor transactions, we reviewed the results of our proprietary survey of independent sponsor transactions occurring during 2015-2017. Our valued network of independent sponsors and capital partners contributed 225 submissions to this report, with approximately half of the covered transactions occurring in 2017.

According to the Pitchbook 2017 annual report, the median enterprise value to EBITDA multiple was 10.4x. Regardless of the chosen "benchmark," our survey reflected that approximately 70 percent of the subject independent sponsor transactions were consummated at a multiple under 6x, while nearly one-third of the transactions had a multiple under 5x. No matter the benchmark, the ability to generate investment opportunities at attractive valuations will always garner attention from capital partners.

In this type of market, as buyers look to differentiate themselves in competitive situations, the personal connection and trust with the seller often can dictate the winning bidder. Many times, these desired dynamics are evidenced by the presence of a seller note or other deferred payments. Of the respondents in our survey, 45 percent reported the inclusion of a seller note, demonstrating what is often an edge for an independent sponsor in its ability to better relate to the individual seller through either an entrepreneurial/operator background or more limited "portfolio" of companies.

In the past, we often saw independent sponsors engaging in transactions with enterprise values under $25 million. While that segment of the market is still fertile ground for independent sponsors, we are seeing independent sponsors closing larger transactions as well. Consistent with this theme, approximately 20 percent of our survey responses reflected more than $20 million of aggregate equity invested in the transaction, often corresponding to deals with enterprise values greater than $40 million.

One valuable component of the independent sponsor economics is the closing fee, overwhelmingly based on the enterprise value of the target. A majority of our submissions reported a closing fee greater than 1.5 percent, with around 30 percent of the responses showing greater-than 2 percent closing fees to independent sponsors.

In many cases, the independent sponsor uses funds from its closing fee to increase the amount of equity invested by the independent sponsor in the transaction. The most common response in our survey reflected the independent sponsor rolling all of its closing fee, with about 60 percent of the responses having an investment by the independent sponsor of at least 50 percent of the closing fee. While the capital partner clearly prefers to see further alignment of interests with the independent sponsor, in only 14 percent of the responses was the independent sponsor required to roll all of the closing fee into equity by the capital partner.

Another pillar of the economics for the independent sponsor is an ongoing management fee. Interestingly, 41 percent of survey responses reflected management fees based on straight dollar amounts between $100,000 and $250,000, with 23 percent of the responses showing $250,000 to $400,000 management fees for the independent sponsors. We also often see the management fee calculated as a percentage, and in these instances, 88 percent of our survey responses reported

management fees based on a percentage of EBITDA, with over half of the responses reflecting management fees greater than 3 percent of EBITDA.

The last, and certainly not least, component of the independent sponsor economic package is the “promote” or “carried interest.” The most common structure of the equity investment by the capital partner was a preferred equity instrument with a preferred return component, liquidation preference and a catch-up. Unquestionably, every deal is different and the underlying economics of the target acquisition will impact the promote, so it is not surprising that the survey responses on this topic varied. However, the most common structure from our respondents was a simple 20 to 30 percent promote without performance hurdles (34 percent of the responses), with over half of the responses reporting a 15 to 30 percent promote.

Consistent with our experience over the years, when the carried interest is premised on a performance hurdle for returns to the capital partner (and not a simple promote), approximately two-thirds of the time, the hurdle was based on cash on cash returns. In the transactions where the hurdle is based on IRR, the most common construct was 10 percent IRR, 20 percent IRR and 30 percent IRR hurdles for the first three tranches of the carried interest. Regardless of which performance hurdle is used, in those transactions, almost two-thirds of the submissions reflected a 10 to 20 percent carried interest upon achieving the first hurdle, with almost half of the responses maxing out the carried interest between 20 and 30 percent, and around 8 percent of the responses showing a potential carried interest at more than 30 percent.

In addition to the economic package, an independent sponsor typically focuses on the post-closing governance structure for the target company. Based on our survey responses, it is most common for the independent sponsor to have one board seat, though around 30 percent of the responses showed a majority of the board appointed by the independent sponsor. Many times, this majority representation is the result of the equity being provided by a syndicate of family offices or high-net-worth individuals, or an otherwise non-control capital partner.

Finally, one of the most relevant issues for independent sponsors (because they do not have a committed fund) is responsibility for dead deal expenses. Based on our survey, it is most common for the independent sponsor to bear half or less of dead deal expenses, with a quarter bearing none. In those situations where the independent sponsor controls the board or otherwise has partnered with more fundamentally passive capital partners, it is more common to see the independent sponsor bearing a larger portion of dead deal expenses.

It’s no secret that the “dry powder” held by private equity funds continues to accumulate as a result of record fundraising in recent years and an ultra-competitive market for targets. Given the survey results, it’s not surprising that these dynamics have led to heightened interest in the opportunities independent sponsors present. At the same time, there have been multiple public reports of traditional private equity funds deciding not to raise a new fund in order to pursue “deal by deal” economics, which is the hallmark of independent sponsor transactions.

Upon a closer look at the economics (and underlying financial models) of independent sponsor transactions, simple math demonstrates the compelling value proposition many independent sponsors offer. Expect this reality to continue in the coming years.

Recently named “Law Firm of the Year” in *Mergers & Acquisitions* magazine’s 2017 Mid-Market M&A Awards, McGuireWoods is frequently recognized for its deal work and innovations that distinguish the firm as an industry leader, including its efforts in the independent sponsor market. In addition to an annual independent sponsor conference, the firm also regularly hosts independent sponsor regional networking groups throughout the country. These roundtable groups convene independent sponsors to share best practices, connections, advice, deal leads and experiences in a trusted environment. We have established groups in Chicago, Dallas, the Great Lakes region, LA, New York and the Southeast region. A list of upcoming events can be found here. For more information, please contact one of the lawyers noted above, or Amy Norris.