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INDEPENDENT SPONSOR DEAL SURVEY

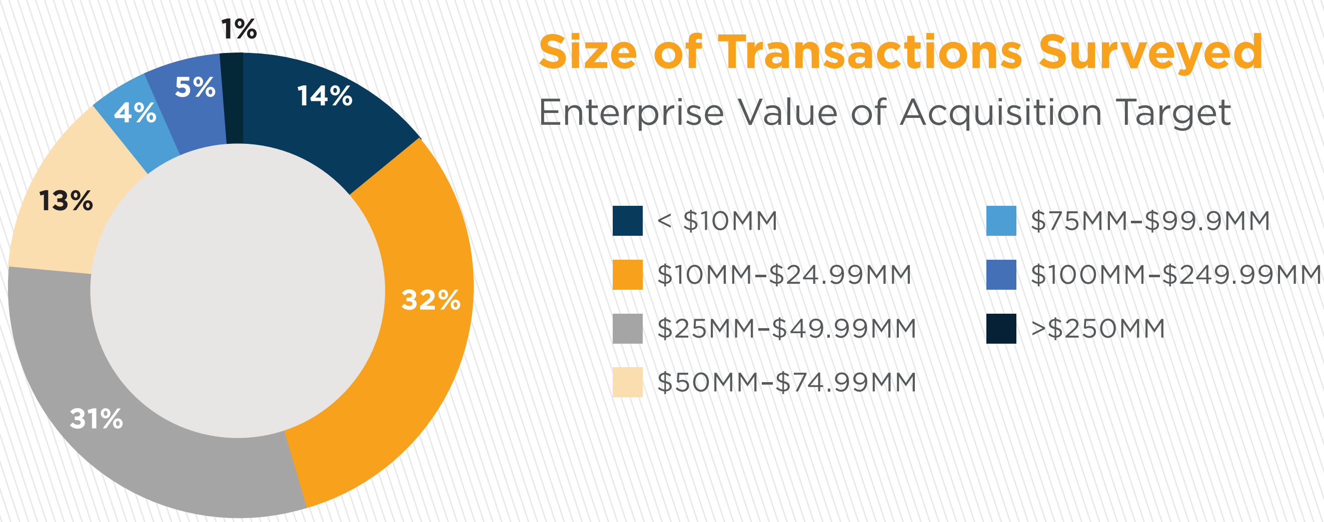
SUMMARY AND ANALYSIS

Overview

This deal study is based on nearly 300 detailed survey responses related to independent sponsor-led transactions consummated in 2018, 2019, 2020 and 2021. The study discusses the most useful findings of the survey data and identifies prevailing market trends in economic and other terms of independent sponsor transactions.

McGuireWoods' survey is the largest of its kind, and this deal study is the firm's most comprehensive analysis to date regarding market terms in independent sponsor transactions. Please contact the authors of this deal study with any questions regarding the findings or the underlying survey data. McGuireWoods private equity partners Jeff Brooker, Greg Hawver and Jon Finger presented a portion of this analysis at the October 2021 McGuireWoods Independent Sponsor Conference in Dallas.

Size and Pricing of Transactions Surveyed



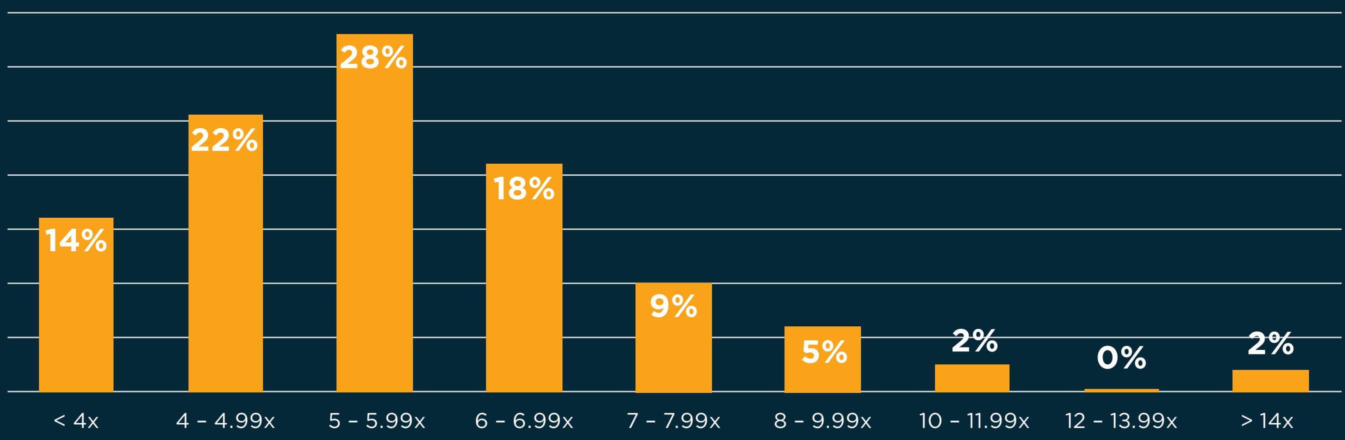
The survey confirmed that the vast majority of independent sponsor transactions are occurring in the lower middle market, a much sought after portion of the M&A environment. More than 75% of the transactions surveyed involved target companies with an enterprise value between $10 million and $75 million. Relatedly, approximately 75% of transactions surveyed involved an aggregate equity check of $5 million to $50 million, excluding debt financing and seller rollover equity. At the same time, a good number of independent sponsor transactions involve target companies with an enterprise value near and above $100 million, which reflects the strength, acceptance and evolution of the independent sponsor segment within private equity.

In the current frothy M&A environment, the pricing of most independent sponsor transactions reflects relatively reasonable multiples of earnings before interest, taxes, depreciation and amortization (EBITDA). Roughly two-thirds of the transactions surveyed had a purchase price less than six times (6x) the target company's EBITDA. More than 80% of the transactions had a purchase price less than seven times (7x) EBITDA and more than 90% of the transactions had a purchase price less than eight times (8x) EBITDA.

Independent sponsors appear to be leveraging relationships, industry experience, operational expertise and other advantages to close deals at attractive prices. While independent sponsors can and do compete in highly competitive situations at higher multiples, most independent sponsor transactions result from situations in which the sponsor identifies and capitalizes on opportunities that provide value in the current market.

Multiple of Adjusted EBITDA

Purchase price paid for the target in the underlying M&A transaction, measured as a multiple of target EBITDA.



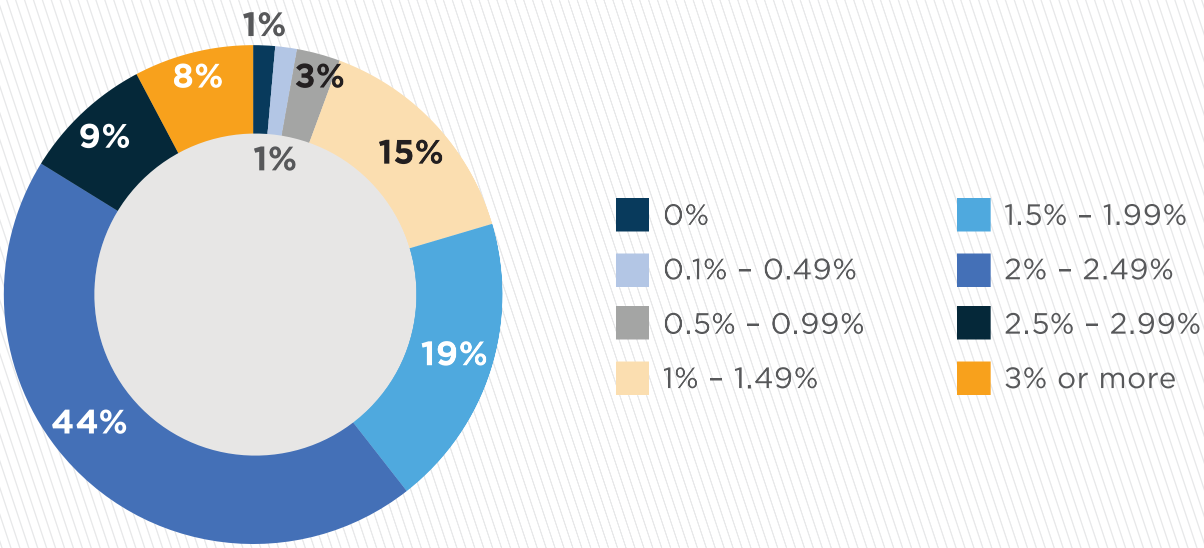
Economics Paid at the Closing of the Transaction

The economics the independent sponsor receives at closing are one of the three pillars of the typical independent sponsor economic package. This deal study uses the term "closing economics," but the closing economics to the independent sponsor can take a variety of forms. Examples include: (1) due diligence and structuring fees the portfolio company pays for the independent sponsor's pre-closing and short-term post-closing efforts, (2) profits interest units granted to the independent sponsor at or in connection with the closing, and (3) closing fees. The structure of the closing economics can implicate regulatory and licensing considerations, so the independent sponsor should consult knowledgeable legal counsel prior to structuring, documenting or accepting any closing economics.

Nearly two-thirds of the transactions surveyed reported closing economics between 1.5% and 2.49% of enterprise value of the target company, and nearly 80% reported closing economics between 1% and 2.49% of enterprise value. Closing economics equal to 2% of the enterprise value were the most common result for transactions with enterprise values between $10 million and $75 million. Generally, as deal sizes increased, the closing economics as a relative percentage of enterprise value tended to decrease. Not surprisingly, this trend was especially pronounced for very large deals.

Size of Closing Fee to Independent Sponsor

As a Percentage of Enterprise Value



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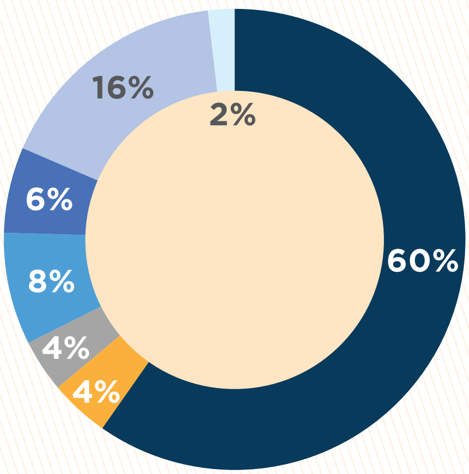
In 60% of the transactions reported, the independent sponsor's equity investors received no closing economics. It should be noted, however, that the prevalence of equity investors receiving closing economics varied significantly by the type and number of equity investors. Generally, a single equity investor or small group of equity investors was more likely to receive closing economics than a larger group of investors. Investors that generally structure their transactions with closing fees, such as control private equity and mezzanine debt funds, tended to receive closing economics more often than other types of equity investors.



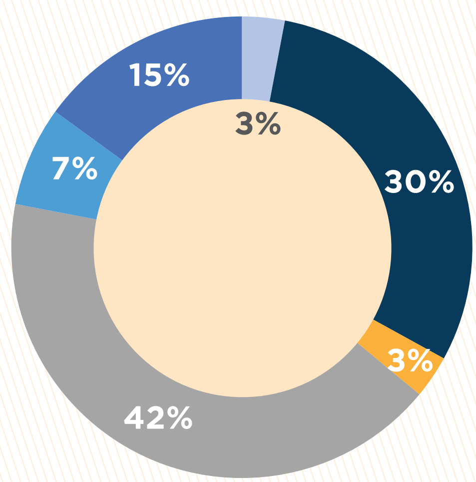
Closing Fees Paid to Equity Capital Provider

- None
- 0.1% – 0.49%
- 0.5% – 0.99%
- 1% – 1.49%
- 1.5% – 1.99%
- 2% – 3%
- > 3%

Independent sponsors rolled more than half of their closing economics into equity in the transaction in approximately 60% of the transactions surveyed, with a rollover of 100% of closing economics being the most common result. Reinvested closing economics reflect independent sponsors' confidence in their deals as well as equity investors' preference that at least a portion of the closing economics be reinvested into the transaction. The tax treatment of closing economics varies based on the structure and form of consideration being paid to the independent sponsor, and is an important consideration when determining the amount of rollover.

Closing Fees Rolled Into Deal by Independent Sponsor

- 0%
- 1% – 24.99%
- 75% – 99.99%
- 25% – 49.99%%
- 50% – 74.99%
- 100%



Management Fees

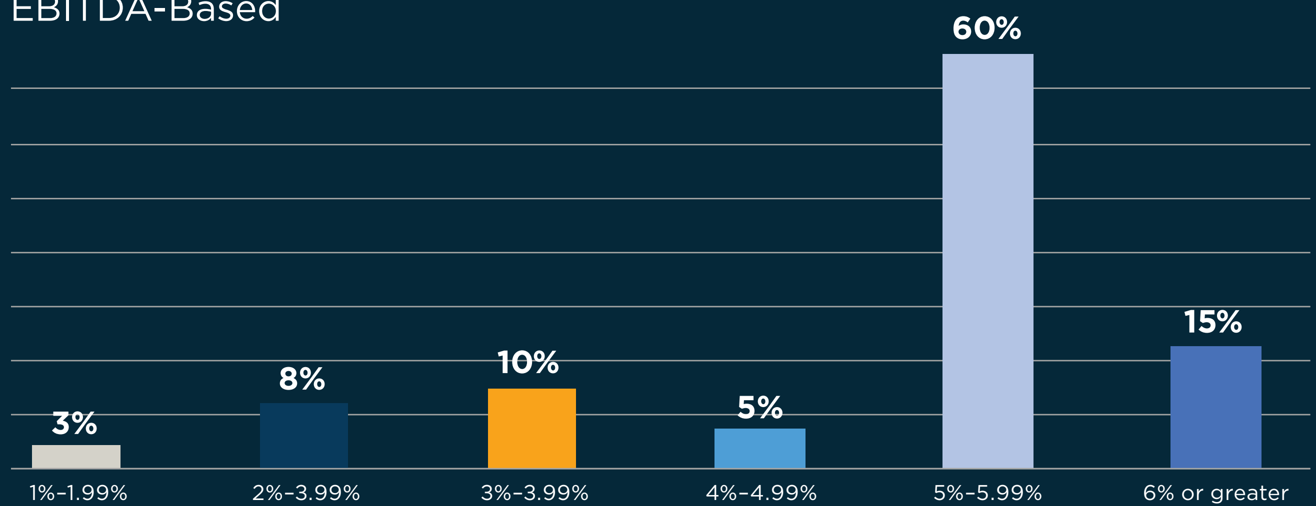
The management fee is the second of the three pillars of the typical independent sponsor economic package. The management fee is a fee paid by the portfolio company to the independent sponsor for consulting, management and similar services during periods following the closing of the acquisition of the portfolio company. The management fee is most often paid on a quarterly basis. As with other private equity firms, management fees provide an ongoing source of income for an independent sponsor to pay for its internal operational costs, expenses and other financial outlays.

Nearly 85% of management fees were calculated based on the trailing 12-month EBITDA (TTM EBITDA) of the portfolio company, as opposed to a set dollar amount. Most of the transactions surveyed, fully 60% of all transactions, reported a management fee to the independent sponsor of 5% of TTM EBITDA.

It is important to note, however, that typically these management fees are subject to a minimum and/or maximum amount, and those floors and caps most often are set dollar amounts, instead of percentages of TTM EBITDA. More specifically, 76% of transactions surveyed included a floor for management fees; 70% included a cap on management fees; and 60% had both a floor and a cap. The vast majority of floor amounts (89%) fell in the range of $100,000 to $399,000, with the range of $200,000 to $299,000 being the most common result (49%). Of the transactions that included caps, the majority of caps (58%) fell within the range of $500,000 to $999,000. These market ranges are less pertinent to larger transactions, which generally (and not surprisingly) featured higher caps and floors. As inflation continues to rise, independent sponsors should consider whether caps and floors should be adjusted annually.

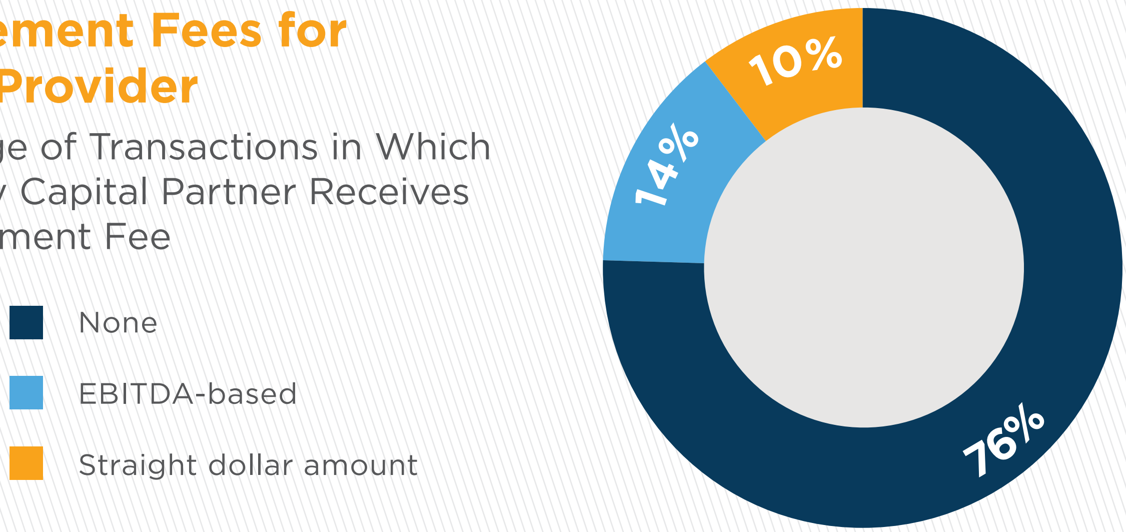
Amounts of Management Fees

EBITDA-Based



Management Fees for Equity Provider

Percentage of Transactions in Which the Equity Capital Partner Receives a Management Fee

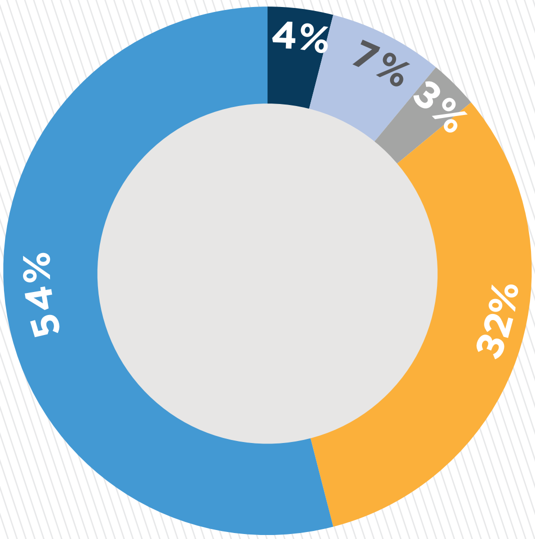


The independent sponsor's equity investors did not receive a management fee in 75% of the transactions reported. This data reflects a broad theme of independent sponsors truly adding value rather than merely being brokers or finders. Moreover, it illustrates the value equity investors ascribe to the independent sponsor's post- closing efforts and the value proposition of independent sponsor-led transactions for all sorts of investors, particularly family offices and other investors who are not actively involved in the operations of the portfolio company following the closing. Where the independent sponsor's equity investors did receive a management fee, the transaction tended to involve fewer equity investors (often just a single equity investor) and investors of a type more likely to structure their transactions with management fees, such as control private equity and mezzanine debt funds.

The management fee in most cases is subordinated to the portfolio company's senior and mezzanine debt, if any, and payments of the management fee are generally restricted if the portfolio company is not in compliance with its debt covenants or if payment of the management fee would cause the portfolio company not to be in compliance with such covenants on a pro forma basis. This deal survey examined the effect of the portfolio company's credit agreements on the management fee.

In more than half of the transactions surveyed that had credit agreements — 54% — payments of the management fee paused while not permitted by the portfolio company's credit agreement, but continued to accrue without a cap on the amount of such fees that may accrue. In an additional 32% of the transactions surveyed that had credit agreements, payments of the management fee paused while not permitted by the portfolio company's credit agreements, but continued to accrue up to a cap. Accordingly, in the vast majority of transactions — 86% of all transactions in which the portfolio company had a credit agreement — the management fee continued to accrue while blocked, at least to a degree.

Credit Agreement Restrictions on Management Fee



Fees do not accrue while blocked

Fees not blocked even if default

Management agreement terminates entirely upon default

Payments pause, fees accrue (up to a cap) while blocked

Payments pause, fees accrue while blocked (no cap on accrual)

The management fee will rarely stop accruing entirely or terminate, as evidenced by the relatively small number of transactions that reported those outcomes (just over 4% and 2%, respectively). This is understandable, because often in these circumstances the equity investors actually need the attention and efforts of the independent sponsor more than ever. Accordingly, altering the management fee is not viewed as productive to the underlying investment in the long term.

Carried Interest

Overview

Carried interest is the independent sponsor's share of profits that otherwise would have been paid to the equity capital investors in respect of their equity securities. Alternatively referred to as a "carry" or "promote," this is the third pillar of the independent sponsor economic package. Carried interest is usually documented in the distribution waterfall provisions of the limited liability company agreement of the holding company for the investment or in a separate carry entity that invests directly into the holding company.

There are two basic models for the carried interest: (1) a "variable with hurdles" model with multiple escalating hurdles (typically based on a multiple on invested capital (MOIC) and/or internal rate of return (IRR)) that, once achieved, result in an increasing percentage of the profits being allocated to the independent sponsor; and (2) a "straight percentage" model in which, following a return of capital to equity investors and often a preferred return, the independent sponsor receives a straight percentage of all profits.

Variable-With-Hurdles Model

Of the transactions surveyed, [61%] use the variable-with-hurdles model. While private equity funds and mezzanine debt funds did utilize the straight-percentage model in a number of transactions surveyed, the variable-with-hurdles model tended to be preferred by most private equity funds and mezzanine debt funds (as well as many family offices).

[61%]

of transactions surveyed used the variable-with-hurdles model

The hurdles in this model customarily are calculated based on distributions and other proceeds equity investors received in respect of their equity securities, excluding any debt investments, management fees, closing economics or expense reimbursement. Hurdles are typically calculated using MOIC and/or IRR metrics. MOIC is the most common measure, used in 70% of transactions that utilize the variable-with-hurdles model versus 13% of such transactions that use IRR hurdles. As a third option, 17% of such transactions used a hybrid approach, such as (1) including both IRR and MOIC hurdles at each stage of the waterfall, or (2) switching from MOIC to IRR hurdles after a certain time period. The hybrid approaches typically are constructed to protect the equity investors from investments with long hold periods and relatively low IRR.

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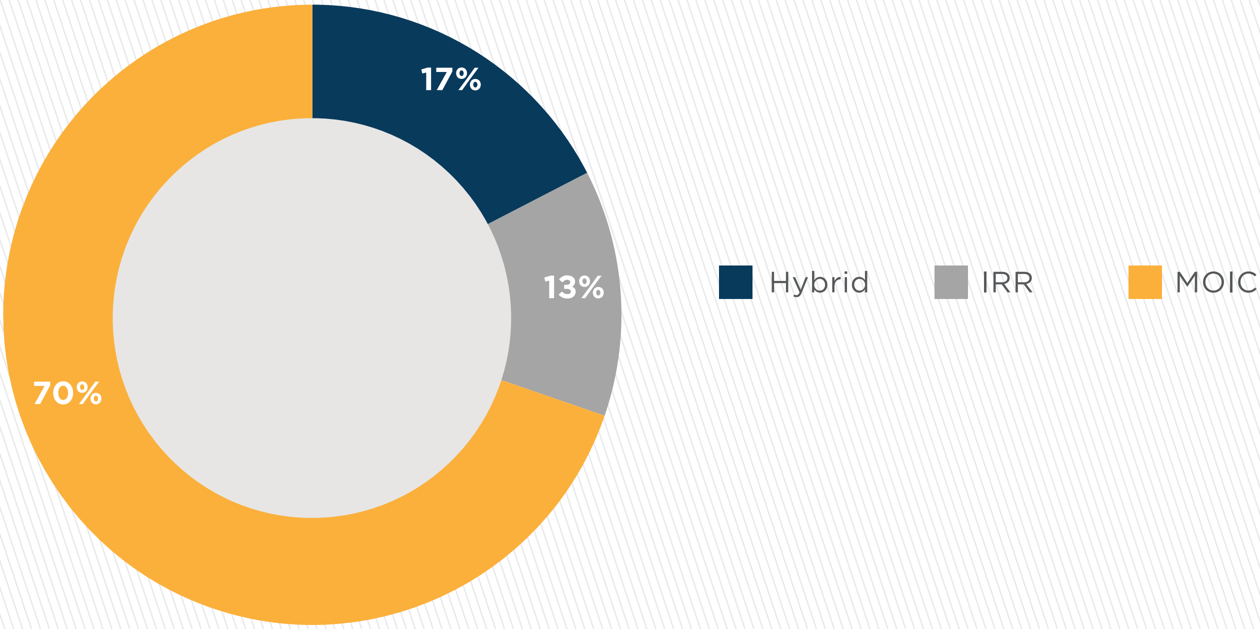
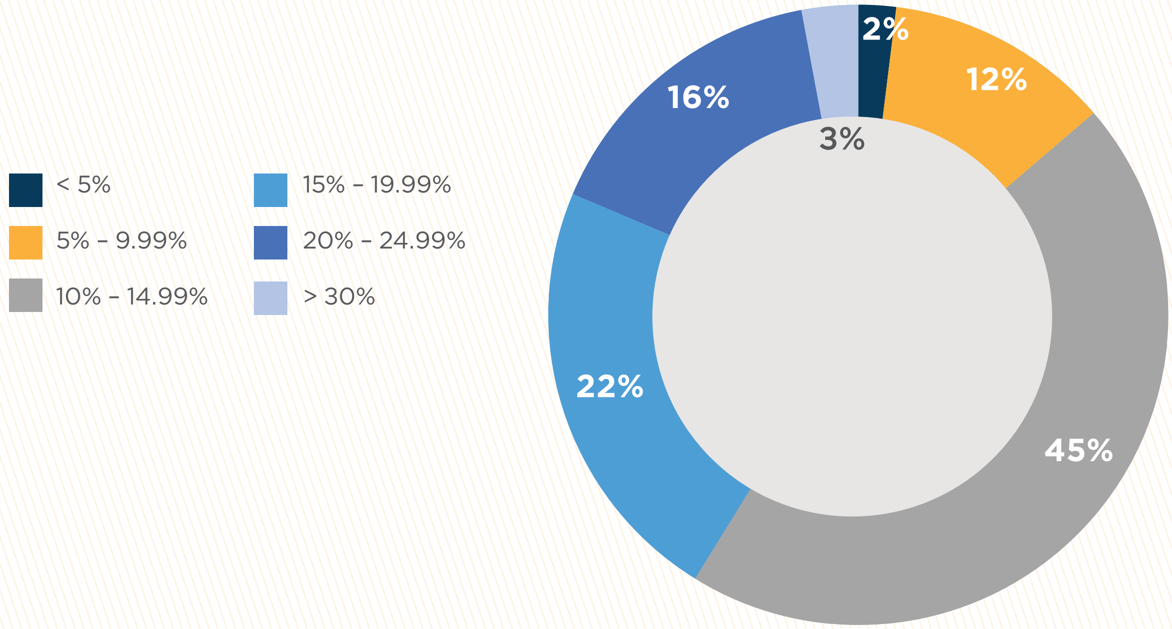
Carried Interest Hurdles – MOIC vs. IRR



While McGuireWoods has seen many examples of complex waterfalls with many hurdles, the survey results demonstrate that independent sponsors and their equity investors are most often limiting their waterfalls to two or three hurdles, with 42% of deals using variable MOIC hurdles having three hurdles and 24% of deals using variable MOIC hurdles having two hurdles. Further illustrating this inclination to keep the waterfall relatively straightforward, only 8% of deals using variable MOIC hurdles used four hurdles and only 4% of deals using variable MOIC hurdles having five or more hurdles. Deals using variable IRR hurdles had an even stronger tendency to limit the number of hurdles to three or fewer hurdles.

In the vast majority (91%) of transactions using MOIC hurdles, the first hurdle was set between 1.0 and 2.0 MOIC. The most common carry percentages to the independent sponsor after achieving the first hurdle ranged from 10% to 14.99% (representing 45% of transactions using MOIC hurdles), with a carry percentage ranging from 15% to 19.99% (representing 22% of transactions using MOIC hurdles) also a common result.

Carried Interest Distributions After First MOIC Hurdle



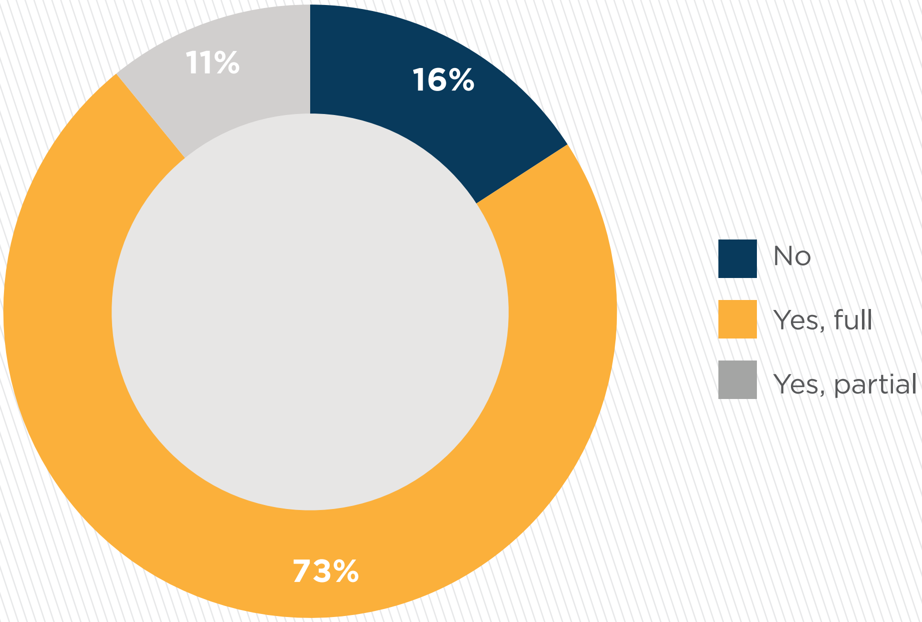
After the first hurdle, each subsequent hurdle is typically 0.5 to 1.0 MOIC higher than the immediately preceding hurdle and the carry percentages to the independent sponsor typically increase by 5% to 10% per hurdle. Only in a relatively small number of deals (32%) was the highest hurdle greater than 3.0 MOIC.

In the majority of transactions surveyed, the carry percentage to the independent sponsor after achieving the second hurdle ranged from 20% to 24.99%. After achieving the third hurdle, the carry percentage to the independent sponsor was relatively evenly distributed from 20% to 30%.

In our experience, the highest carry percentage is heavily influenced by the quality of the deal and competitive tension reached in the independent sponsor's negotiations with the equity investors. Some independent sponsors focus on the higher-return scenarios and spend fewer "negotiating chips" on the lower-return scenarios.

Catch-Up to Independent Sponsor

Prevalence of Catch-Ups



In many transactions, after achieving each hurdle, the independent sponsor receives a "catch-up" to the higher carried interest percentage associated with such hurdle based upon prior distributions of profits. The survey responses revealed that the vast majority of independent sponsor transactions are structured with catch-ups. Specifically, 73% of transactions had a "full catch-up," meaning that upon achieving a hurdle, the independent sponsor was caught up to the new carried interest percentage implied by the newly achieved hurdle, with the catch-up calculation taking into account all profits from the first dollar of profits. An additional 11% of transactions had a "partial catch-up," meaning that either (1) the independent sponsor does not catch up to the first dollar of profits, or (2) upon achievement of a hurdle, the independent sponsor receives an increased portion of distributions but does not fully catch up to the higher carried interest percentage back to the first dollar of profits. The survey shows that 16% of transactions had no form of catch-up. In our experience, the catch-up often is not adequately clarified at the term-sheet stage despite being essential to understanding the terms of the carried interest.

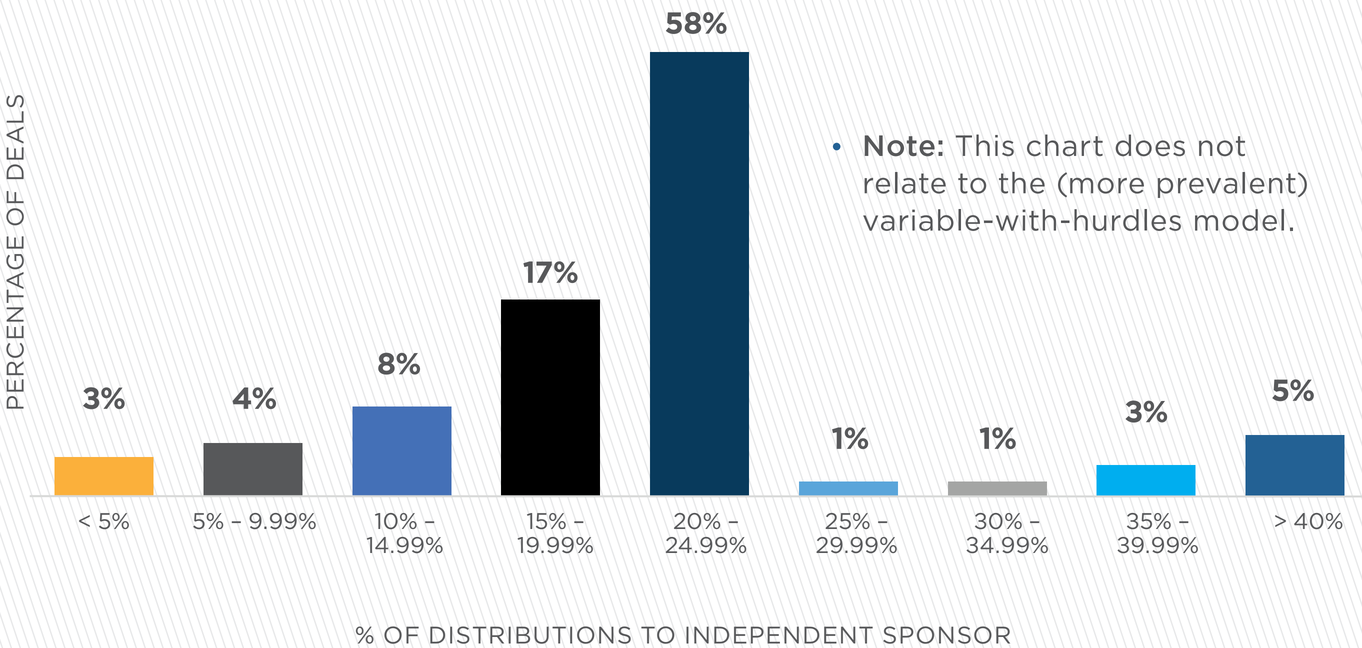
Carried Interest

Straight-Percentage Model

Of the transactions surveyed, 39% used the straight-percentage model. Those transactions tended to have a larger number of equity investors, who were more likely to be family offices and high-net-worth individuals rather than private equity or mezzanine debt funds. This is consistent with our experience, as it is not uncommon for “pass the hat”-style equity financings to use the straight-percentage model due to simplicity and negotiating dynamics as well as historical acceptance of the model.

More than half (58%) of the transactions that used the straight-percentage model had a carried interest percentage to the independent sponsor equal to 20%. This is consistent with the traditional “two and twenty” private equity model. Only 10% of the transactions that used the straight-percentage model had a carried interest percentage greater than 20% and only 15% of such transactions had a carried interest percentage less than 15%.

Straight-Percentage Model – Carried Interest Percentage to Independent Sponsor



- **Note:** This chart does not relate to the (more prevalent) variable-with-hurdles model.

Broken-Deal Costs

In the majority of the transactions surveyed, equity capital providers agreed to pay some or all of the broken-deal costs (i.e., the transaction fees and expenses if the transaction did not close). This is even more common in control buyouts in which a control private equity investor is the independent sponsor's primary equity capital partner. In such transactions, the control private equity investor was responsible for all of the broken-deal costs in 61% of transactions. In only 21% of such transactions was the independent sponsor responsible for 25% or more of the broken-deal costs.

In smaller transactions and transactions with many equity investors, it was more common for the independent sponsor to be responsible for some or all of the transaction fees and expenses if the transaction did not close. In these circumstances, independent sponsors are "staging" workstreams and otherwise selecting service providers that are true partners in helping them grow their firm.

In only

[21%]

of control private equity-backed buyout transactions was the independent sponsor responsible for

[25%]

or more of the broken-deal costs.

Conclusion

In recent years we have witnessed continuously growing success of independent sponsors in the private equity market – both in the number and size of transactions being consummated. Indeed, the independent sponsor segment of private equity has become a separate asset class with its own set of market terms and norms. As that market continues to develop and the underlying economic environment changes, we intend to publish additional deal studies reflecting the evolution of the independent sponsor marketplace. In the meantime, please do not hesitate to contact McGuireWoods for best-in-class advice for your independent sponsor transactions.

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A video recording of the discussion of our survey results led by McGuireWoods private equity partners Jeff Brooker and Greg Hawver at the October 2021 McGuireWoods Independent Sponsor Conference in Dallas can be viewed on **YouTube**.

For further insights on independent sponsor issues and transactions, please listen to McGuireWoods' independent sponsor podcast "Deal-by-Deal", hosted by private equity partners Jeff Brooker, Greg Hawver and Rebecca Brophy, available on **YouTube** and the **McGuireWoods website** as well as **Apple Podcast** and **Amazon**.

For additional resources and thought leadership related to independent sponsor transactions as well as information on the industry-leading annual McGuireWoods Independent Sponsor Conference in Dallas, please visit **independentsponsorconference.com**.

Legal Disclaimer: The data summarized in the Deal Study is subject to limitations with respect to the collection and presentation thereof, including the accuracy of the survey respondents in reporting such data. McGuireWoods LLP makes no representation as to the accuracy of the data summarized in the Deal Study or this paper. The authors have attempted to present the data in the most useful and accurate format for its intended audience.

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