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RISKS AND REWARDS OF FREEDOM:

How independent sponsors can increase their chances of success

EXECUTIVE SUMMARY

For independent sponsors, there is no well-trodden path to follow – a reality that is actually a part of the appeal for the entrepreneurial dealmakers who strike out on their own.

Like the private equity sector of the early 2000s, the independent sponsor model is in an early state of evolution. Initially formed by the few brazen trailblazers who broke away from the institutional pack, the model has been legitimized by the successes of some very talented and experienced investors who are bringing a much-needed institutional mindset to the lower middle market.

The good news: An abundance of ready capital and growing interest in direct investment have brought the model off the sidelines and into the mainstream of the M&A market. And with no barriers to entry, the independent sponsor model is open to anyone willing to accept the risks.

The bad news: There is virtually no room for error. With personal capital at stake and without the safety net of a fund, a broken deal will set you back and may even derail your plans – and not just because of the sunk costs. Your personal reputation is at stake, after you looked that founder in the eye and promised you would get the deal done.

How do you bolster your credibility with capital providers and put in place the kinds of systems and networks that will increase the likelihood of a successful close?

We have drawn on our years of experience serving new and longtime independent sponsors. In addition to insights and best practices for independent sponsors at any stage of their development – whether getting ready to close the first deal, accelerating growth post-close, or managing a growing portfolio of companies while continuing to seek new deals – we have included an in-depth profile of a first-time independent sponsor, suggestions for how to set yourself apart as a sponsor, and investment criteria for family offices. We also sat down with Claudine Cohen, a principal and leader in CohnReznick's Transaction Advisory Services practice, for an in-depth discussion of how independent sponsors are engaging in the current market.

Note: Quotes throughout this report are from our Independent Sponsors Forum video series (https://www.cohnreznick.com/insights/independent-sponsors-forum). Some have been lightly edited for clarity or length.

PROFILE OF A FIRST-TIME SPONSOR:

Valley Ridge Investment Partners

Closing the first deal as an independent sponsor is akin to having your first child. Everyone tells you how hard it's going to be, but until you go through it yourself, you can't appreciate just how difficult – and how rewarding – it can be.

"It's a special challenge for first-time independent sponsors, because it's almost a catch-22," said John Sheffield of Valley Ridge Investment Partners when he sat down with Claudine Cohen for CohnReznick's Independent Sponsors Forum series. "As we tried to go out and speak with financing sources early on, one of the first questions they would ask is, 'Is this your first deal?' The second question is, 'Do you have this deal under LOI?' The financing sources didn't want to waste time until they knew that we had something tangible to discuss."

Despite the challenges, Valley Ridge closed its first deal in early 2019, roughly a year after Sheffield and partner Mark Tedford set up shop. Even more impressive, the sponsors were able to choose from five fully financed proposals.

One part of Valley Ridge's formula for success is that they focus on a limited number of potential deals. "We hear stories of other independent sponsors that look at 40 or 50 or 60 deals," Sheffield said. "We really looked at about a dozen, but we spent a lot more time on each of those transactions. There were two that we spent a considerable amount of time on, one of which didn't work out right at the point of the LOI. We had negotiated everything, we had provided what I thought the seller wanted. And ultimately, he had been a part of that company for 24 years and decided he didn't want to sell. So that is a risk that occurs from time to time."

The deal that did close – Raleigh, N.C.-based National Power – was sourced through a traditional investment banking process, leveraging Sheffield's extensive investment banking experience and strong network.

Another critical ingredient for success was sticking to the manufacturing sector, where Sheffield and Tedford have the most experience. "As we've talked to folks about what makes independent sponsors successful, you really have to have some special sauce – some knowledge of the industry that you're focusing on," Sheffield said. "… Mark has significant experience working with manufacturing firms and improving their processes, and I've had success as a banker and then also as a CFO working in manufacturing-type companies."

Investing extra time in upfront diligence was another critical success factor for Valley Ridge. "By the time we went to market to our financing sources, we had done a significant amount of diligence on our own," Sheffield said. "We purposely wrote a very detailed value creation memo. The feedback that we got was that the preparation we had done was better than most that they had seen."

Another critical ingredient? Advisors with deep knowledge of the independent sponsor model. "The advisors that you have in accounting and legal are really true partners that I would encourage everyone to focus on early," Sheffield said. "… Don't wait for a transaction. Find your partners early."

SPECIAL SAUCE:
What sets an independent sponsor apart?

Maybe it's too early to declare that the next decade will be the age of the independent sponsor – but then again, maybe not. As good deals remain hard to find, independent sponsors bring a lot of ingredients to the table that capital and debt providers appreciate.

Proprietary deals. Deal sourcing for institutional investors has become much more difficult, with dozens of firms vying for the same companies. Independent sponsors, however, are uniquely talented at finding target companies that aren't yet for sale. CEOs at the lower end of the market tend to prioritize day-to-day operations without wondering what their companies can fetch in the M&A market. There are many examples of independent sponsors persuading business owners, who are often unsure of timing, into sales beneficial to both parties. Inadvertently, sponsors can play a pivotal role in founder succession planning.

Rapport with business founders. Independent sponsors have a natural edge over institutional investors in establishing trusting relationships with founders. Sponsors who aren't beholden to the restrictions of a PE fund also typically are willing to invest the time to get owners comfortable with the fact that they may need to bolster the executive team with outside talent to build value.

Opportunity for direct investment. "Investors are much more interested in accessing direct deal flow," says Mona Marquardt, managing director for private fund placement with Trailmark (formerly Fortress Group). "… The investors that we work with are predominantly fund investors, but almost all of them have some interest in direct deals." Family offices, in particular, increasingly are turning to independent sponsors as an avenue for making direct investments. Whether or not those investments are controlling, family offices that invest in deals through an independent sponsor have a far greater degree of visibility into the target, as well as influence on post-close decisions.

However, just because they bring a lot to the table, that doesn't mean that independent sponsors are an automatic shoo-in with capital providers. Investment credibility takes time to earn, and independent sponsors typically must work even harder than PE funds to demonstrate why capital sources should invest in their deals.

A few of the characteristics that tend to help independent sponsors differentiate themselves include:

Story. Successful independent sponsors are master marketers who know how to craft a clear and compelling investment thesis. In part, this is an inherent advantage of the single-deal structure: Whereas PE funds might struggle to articulate a message about a pool of investments, independent sponsors have an advantage in articulating why a single asset is worth financing. But the best independent sponsors go further. They develop a strategic investing philosophy early on, and then they refine it into a succinct pitch that they can clearly communicate when networking with business owners and capital providers.

Focus. Success in closing the first deal (as well as the second, and often the third) depends on a stellar track record established during the sponsor's earlier tenure as a private equity investor, investment banker, or operational leader. Successful sponsors know their domain well, and they maintain a laser-like focus on it.

Governance. Institutional investors expect institution-level governance. When the capital stack includes PE funds or large family offices, they will expect to see a clear governance plan. How will decisions be made? What type of team, systems, and processes are in place?

Risk management strategy. Even more than for institutional investors, the independent sponsor's success rides on thorough diligence and "what-if" thinking. "Since they don't have a deep pocket, if things don't go as expected and more money has to go into the company, where is that going to come from?" said Jeri Harman, founder and chairman of mezzanine fund Avante Capital Partners. "… We can be part of the solution, but we don't want to be all of the solution."

TOP 3 CRITERIA FOR FAMILY OFFICE INVESTMENTS

The rise of independent sponsors is happening at the same time as family offices are becoming more active investors. Family offices increasingly look to the independent sponsor model to facilitate direct investment in promising assets, and independent sponsors are attracted to wealthy families' deep pockets and patient capital.

According to Mickey McFarlin, head of Family Advisory Services with Stephens Inc., the three criteria that family offices focus on include:

1. Does the independent sponsor **bring value to the transaction**? That value might be industry expertise, management experience, or some other skill set that will increase the transaction's probability for success.
2. Do they have **skin in the game**, whether with their own capital or through economics that are aligned with the other investors'?
3. Do they have a **track record**? Have they had successful investments and exits that show investors they have high likelihood of pursuing a successful transaction?

In a first meeting with a sponsor, investors are focused on the sponsors themselves, including their plans for the future. "We just want to know who they are," McFarlin said. "We want to know their background, we want to know what they are trying to be as a sponsor. Is this the first in a couple transactions on your way to starting a private equity fund? Is this a long-term strategy where you're always going to be an independent sponsor? Is this a holding company strategy? Who are you as people, and what do you want to be, and how can family capital help you towards that path?"

LIFE CYCLE OF AN INDEPENDENT SPONSOR

Getting to the first close

For an independent sponsor, everything rides on the success of that first deal. Following are some insights and best practices to help you increase your likelihood of closing that deal and securing the capital.

Establish your investing approach early

- Lenders and co-investors value sector expertise and clearly articulated strategies, so focus on the sectors where you have the most experience.
- Develop your investing approach as early as possible. Refine it into something you can articulate when networking, cold-calling company owners, or looking for capital providers.
- Determine whether you prefer to invest actively (control/board representation) or passively. How involved do you want to be? This could change on a deal-by-deal basis, but find your strengths and preferences.
- Hire an advisor to validate EBITDA and/or working capital. Once a capital provider is on board, the firm can issue a complete quality of earnings report.

Establish relationships with capital providers and potential co-investors

- Build your network early to avoid a financing scramble when a deal is available.
- Look for the right partners on particular transactions, and don't think of them as simply sources of capital. Look for true partners who embrace the independent sponsor model.
- Inquire about their history with independent sponsors. How many have they financed? What was the check size? What are their criteria? What role do they look to play post-close? Will the capital provider give the independent sponsor leeway in terms of growth initiatives?
- Look for familiarity with deal structure and fair economics in terms of transaction fees/promote, carried interest, and ownership/ongoing management fees. Put in place a management services agreement to clearly define expectations for roles, performance, and compensation.
- Don't limit yourself to family offices and high-net-worth individuals. Although these can be valuable sources of capital for independent sponsors, more tenured firms often work with private equity groups and "mequity" providers (mezzanine + equity). Increasingly, these institutions look to independent sponsors to help source proprietary deals and offload the time-intensive work of bringing smaller add-on acquisitions on board.

Develop a network of talent and advisors

- Find outside talent/executives as early as possible, because many sponsor-led deals require bringing seasoned management to the table. Attend investor and industry events and look for executives looking for their next gigs.
- Don't wait for a transaction to find accounting and legal advisors. Experienced advisors can help first-time independent sponsors navigate the complexities of the market and reduce the risk of broken deals.

After the close

Congratulations! You closed your first deal as an independent sponsor. The post-close period is critical to success, and it actually begins at the inception of the deal. “We call it last chapter first,” VisioCap co-founder David Cunningham explained. “We start any process with a view of what this business should look like when we are at the point of selling, so years down the road. We start with that vision and build alignment with our management team and then figure out exactly what it will take to drive to that result.”

Post-close roadmap

- Alignment with the management team is critical. By the time of close, you should have a shared point of view on where the business will end up at the point of exit.
- The post-close roadmap details the tactics that will achieve that vision for the business.
- The vision and high-level strategic goals should not change, although the tactics might change as the market shifts.

Unlocking value

- Enhance technology and processes to improve visibility and inform decision-making.
- Consider implementing or upgrading a CRM platform to manage relationships.
- Utilize an investor portal to track acquisition projects and portfolio company performance.
- Invest in technology and systems that will add value at exit.

Moving forward

As your portfolio grows, you need to consider your long-term plans. Some sponsors intend to stick with the independent sponsor model long-term. Sponsors that aim to raise a fund will need to think through the implications.

Governance and operations

- Independent sponsors often lack the kinds of systemic deal sourcing processes that have been honed by institutional investors for years. Successful independent sponsors have strong, quasi-organizational structures in place to be able to handle the opportunities that present themselves.
- If the independent sponsor firm includes two or more partners, decide up front how you will divide responsibilities and make decisions. It may be that certain decisions will require combined input.
- Revisit the ideal structure for the business. Most independent sponsors start out as LLCs or limited partnerships. Staying in front of tax rules and regulations may result in a different approach down the line.
- Form a board of advisors with diverse backgrounds to help ensure that decisions are made objectively. Engagement of your advisory board is important; you don’t need any “dead weight.”
- Decide whether, when, and how you will expand the independent sponsor team beyond the firm’s founders. Especially at the junior level, hiring allows for quicker responses to deal opportunities, more deal sourcing, and improved investment management.
- Establish repeatable processes wherever possible. It’s tough to scale without such processes already in place.

Ongoing deal sourcing

- Establish protocols for investigating deal leads.
- Establish a feedback loop to identify ways to streamline and improve the deal-sourcing and due-diligence processes.

Raising a fund

- Are you in it for the long haul? Before going through the work to raise a fund, make sure you are prepared for the 10-year timeline that investors are looking for.
- Why now? Institutional investors expect a cogent explanation of why you are evolving to a fund model and how you will mitigate the inherent risks.

ADVICE FOR FIRST-TIME SPONSORS

Whether you are pursuing the independent lifestyle because you want to return to your roots – cutting smaller equity checks to compelling, less-known companies rather than being pressured to cut bigger checks to less-interesting ones – or you're striking out on your own to concentrate on niche sectors that traditional firms ignore, consider the following words of wisdom from experienced sponsors and their advisors.

The first deal will take longer than you think. "I have worked with 12 to 15 independent sponsors for whom I helped them close their very first deal," said Thomas Zahn, partner with McGuireWoods. "And I would say in the overwhelming majority of cases, the feedback I've received was, 'I thought I'd be able to get the first one done in six months, it took me 18 months.' Make sure that you're prepared for that."

Know *your* story, and tell it well. Remember that capital providers are investing in you, in addition to the specific asset you are vouching for.

Cast a wide net. Don't limit yourself to one type of capital source (family offices, PE funds, mezzanine). "You don't know at any given time what deal is going to be really attractive for a particular investor and what set of circumstances might just align just right for you to receive a great deal with a really great partner," Zahn said. "… I have found folks get into a little bit of trouble doing that where they are too narrow and then need to broaden their process later."

Act quickly to unlock value. The sooner you effect change, the more compounded benefit you will realize at exit. "It's easy to lose time," said VisioCap co-founder Steve Marton. "… It's really important for us to figure out early on what is going to unlock value, and then from Day 1, working really hard to get that done."

Q&A WITH CLAUDINE COHEN

Claudine Cohen, a principal and leader in CohnReznick's Transaction Advisory Services practice who is immersed in the independent sponsor community, shared her insights into how independent sponsors are engaging in the current market.

Q: Independent sponsors have been around for decades but have gained much more attention from the market in recent years, particularly the lower middle market. Why now?

A: Just like any other asset class, the independent sponsor model has evolved. As PE has matured, some of the younger talent at more established PE firms have begun to see the independent sponsor model as an opportunity to go out into the marketplace and establish themselves. Many don't have enough of a track record to form a traditional PE fund, so the independent sponsor model works well. There's also the fact that family offices, which used to fly under the radar, are more visible in the market now and are pursuing direct investments. Many of these family offices don't have the infrastructure to go with the direct model, and the independent sponsor model gives them an easy way to transition. And lastly, there's just an abundance of capital. Access to capital is that much easier for independent sponsors – working with traditional PE, with SBICs who do both debt and equity, or with private debt funds that can also provide some equity as part of their investments.

Q: Experienced professionals who strike out on their own typically head down market, into the $100 million and below category, and they bring an institutional mindset with them. How important is that mindset for independent sponsors when sourcing and transacting deals?

A: You're right that they typically target the lower middle market, but that's also changing. From an enterprise value standpoint they tend to stay under $100 million, but we're certainly seeing them move upstream to do larger deals. Independent sponsors three to five years ago were focused on companies with less than $5 million of EBITDA. Now, more and more of them are going to the $5 million to $10 million range, and many of them are in companies north of $10 million.

That institutional mindset only helps them – it's a seller's market, and there's a demand for good companies. Owners are taking advantage of that to sell their businesses, and many of them are hearing about market conditions through friends and they're hiring advisors to take their companies to market. As advisors are taking them to market, they're reluctant to put individuals or firms that are not from an investment background into a process where they're not comfortable. The investment banking community has become a lot more comfortable with independent sponsors participating in these deals because of their institutional mindset, and also because there's so much capital out there.

In terms of sourcing deals, independent sponsors do benefit from the fact that they don't have a dedicated fund behind them. There's less pressure to deploy capital, which means they tend to source in unique ways, and they can spend more time talking to owners and getting them comfortable with their backgrounds.

Q **As confidence continues to build around independent sponsors, do you think some will do much larger deals than they're doing now? Do you see the asset class branching out in other ways besides deal size?**

A It's all part of the evolution of the independent sponsor model. Among some of the more traditional lenders on the senior side, there's still a bit of reluctance to work with independent sponsors because they question whether the sponsor can close the deal. But lenders have made finding debt so much easier, and it's competitively priced. Independent sponsors are getting reasonable prices on senior, mezzanine, all of it rolled into the bid. Just as the world has changed for sponsors, it's also changed for lenders – their models are changing, and they're also hungry for deals.

We work with a lot of independent sponsors, many of whom have done multiple deals, and over the years they've developed relationships with different sources on the equity and debt sides. So, once they have their LOIs signed, they have a head start on where to go.

Q **What are the most common ingredients for success in independent sponsor-led deals? What are the most common pitfalls for less successful ones?**

A Most of the independent sponsors we work with seem to be partners. Maybe one has a more traditional investment background and one has an operational background with deep sector experience. That type of dynamic allows them to really differentiate themselves. Because independent sponsors have a little more time and less urgency to get the deal done, they tend to spend more time with owners and focus on how they can really help them.

We work with an independent sponsor who comes from a special situations background. He leverages one or two people from an operational standpoint, but he has really stuck to his model of finding unique businesses that might be underperforming, or are in industries that are hard to understand. He was able to close two transactions within a year because he stuck to his approach. It's taking a page out of the strategy of any successful PE firm, which will have an easier time raising new funds if they can show their LPs that they've stuck to their model.

As the asset class grows, advisors are adapting to their needs. Stephens Inc., a financial services firm, formed a "family office solutions group." Over the past three years, we've collaborated across our relationships. They've developed a formula for packaging independent sponsors and making them more "investor-friendly." They're doing the diligence and background checks, such that when that independent sponsor has a deal, they are able to get family offices and other investors comfortable in a relatively short period, with all the homework already done. This is all helping the model evolve and improve.

From a CohnReznick standpoint, I often get the question, "If I end up working with an independent sponsor, don't I have to deal with broken deal fees and the inability to pay for certain services?" The truth is, we've dealt with fewer broken deals with independent sponsors than we have with our traditional sponsor clients. What's rewarding about working with independent sponsors is the depth of the relationship and the value-add we can bring to it. We don't do this in isolation but rely on like-minded parties to collaborate with us.

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