Make Room for the Independent Sponsor

It's no secret that it has become more difficult for traditional private equity firms to raise captive funds. In fact, California Public Employees' Retirement System is looking to further reduce its number of private equity relationships by up to two-thirds. The harder fundraising environment, coupled with investment restraints and increased reporting requirements, has led more investment professionals to complete deals on a deal-by-deal basis as independent sponsors. The independent sponsors' efforts are making more of an impression on the deal business than ever before. Traditional private equity firms are working with independent sponsors to generate deal flow and traditional limited partners that more often want to invest directly into companies are also seeing the benefits of working with independent sponsors. Mergers & Acquisitions Magazine convened a special roundtable to discuss the benefits and challenges of working with independent sponsors. Benesch, Friedlander, Coplan & Aronoff LLP sponsored the event and the excerpted discussion that follows provides a range of perspectives from key players in the industry. Participants included traditional private equity investors, an investment banker, a fundless sponsor, a family office investor and a lawyer.

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Danielle Fugazy: How would you characterize the role independent sponsors are playing in today's market?

Jim Hill: Everybody is seeing more independent sponsors today than they did five years ago. Why is that? There are a number of talented managing directors coming out of private equity firms where they have not struggled with their investments necessarily, but the limited partners have made it more difficult for them to raise money and receive extra fees. Private equity funds are limited to a two percent fee structure and many fees they used to earn are offset by the two percent. If you are a $500 million fund, two percent is only $10 million dollars a year. A lot of experienced private equity professionals have moved away from their firms and decided to work with family offices to close deals.

Howard Romanow: It's been much harder to raise a fund since 2008, and some firms have wound down. All of those professionals in this very mature market have a ton of expertise that is now migrating into family offices or going independent. It used to be a family office would only be able to invest with a fund or a fund-of-funds, but that's not the case anymore. Many are tired of paying the fees charged by private equity firms for the returns they are

ROUNDTABLE PARTICIPANTS:

John Bartholdson, Juniper Investment Company

Baron Carlson, AEA Investors LP

John Fruehwirth, Rotunda Capital Partners

Danielle Fugazy, Mergers & Acquisitions

James Hill, Benesch, Friedlander, Coplan & Aronoff LLP

Howard Romanow, Island Management

David Solomon, Lazard Middle Market

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>
> John Bartholdson, Juniper Investment Company

providing and the incremental risk many are taking to try to generate carry. If you can do it yourself with your own team, you can downsize the risk and downsize the cost structure.

John Fruehwirth: It's substantially harder to raise a first-time fund. It's taking upwards of 18 months in some cases. There is clearly a bifurcation between funds that have performed and can raise capital in two to four months, and others that are taking two years. The regulatory environment has also changed. If you are now managing over $150 million dollars you've got to be SEC compliant, making it more costly to run a fund than it's ever been before.

Romanow: If you go back a bunch of years ago, you became an independent sponsor because you couldn't raise a fund. You were forced to do it, as opposed to you choosing to do it. Today more and more people are choosing to do it for the reasons laid out. It's almost as if they'd rather have the flexibility, control their own destiny, and not to have to deal with all this other stuff.

John Bartholdson: Attractive deals don't have trouble finding capital. An independent model can work extremely well for investors that can source attractive proprietary opportunities. Everybody who has lived through a lifecycle of one or more funds knows that your investment decisions are influenced and sometimes driven by fund considerations and therefore not optimized.

Baron Carlson: Ten years ago fundless sponsors had a negative connotation. The private equity community is recognizing that there are many independent sponsors out there that have had very good success in driving very high return deals. They are typically focused with a lot of depth and that's why a lot of private equity sponsors are looking at the independent sponsor community and saying, 'This is a good place to find deals.'

Fugazy: Do you think private equity firms are more interested in working with independent sponsors today then they have been in the past?

Fruehwirth: Absolutely. There are three or four independent sponsor conferences a year now. Three or four years ago there weren't any conferences. Many private equity firms are now proactively seeking out independent sponsors and trying to form long-term relationships. However, one interesting thing will be when the fund's LPs start asking questions like, 'How did you really source the deal? Why am I paying you two percent if the independent sponsor sourced the deal?' There will likely be fallout at some point.

Romanow: For limited partners who can't figure out how to really go direct, but don't want to go into traditional private equity funds, working with independent sponsors is a good middle ground.