The Growing Prominence of Independent Sponsors

By John Fruehwirth, Rotunda Capital Partners | February 5, 2015

Based on market forces and shifting investor attributes, a new hybrid business model has quickly gained acceptance among private equity industry participants including LP investors, operating partners and sell-side M&A intermediaries. This "independent sponsor" hybrid model combines the rigor of traditional private equity (investment acumen and portfolio management) with stronger LP investor alignment on several core issues such as fees, carry and discretion to review each investment opportunity.

The most successful independent sponsors focus on institutional quality deal sourcing, execution and portfolio monitoring and invest a significant personal sum in each deal. As this new hybrid model cannot use portfolio theory and often has different investors in every deal, they generally focus on doing fewer deals, but working each deal harder to drive returns. While they still receive carry on LP invested capital, the majority of the GP compensation is generated by cash on cash returns from their direct investment. This allows more flexible entry and exit timing to optimize market conditions. Rather than take the stock 2% management on committed assets, the independent sponsor's fees are often secured from its portfolio company investments versus asking LP's to pay for the search and organizational expenses before the deals close.

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History Evolves

Since 1960, the private equity industry has continually evolved, but there were largely two different private equity models – the 2/20 format that had dominated for decades by firms that raised funds from companies, state pension plans and other institutional investors. According to Preqin, there are over 5,300 such firms with over $3.7 trillion of assets under management. Firms largely competed based on deal terms, ability to secure advantageous leverage terms and operations expertise. Some firms began using the operating partner models and started to pick industry verticals. The largest funds such as KKR and Carlyle began to manage multiple asset classes and sought larger pools of assets under management. There were outliers who were able to garner more carry or other terms, but the basic GP/LP model was relatively consistent.

On another front, there have always been deal finders, brokers or individuals putting deals together, but these brokers/fundless sponsors often lacked their own capital, systematic deal processes or ability to drive portfolio company performance. They arranged deals primarily by finding a deal and partnering with an established fund to execute and manage the deal. They receive upfront fees and sometimes, back-end equity interests in the deal.

A Changing LP Environment

The Great Recession accelerated the change in industry fundamentals. While the standard private equity model will likely continue to thrive, LP's started searching for ways to better align incentives with the standard private equity fund. They generally disliked the sizeable annual management fees, wanted more transparency, sought investment discretion and tried to fix other inherent GP/LP model flaws.

The LP's started to focus on the six largest structural issues with their fund investments:

1. The need to realize a high IRR could shorten the holding period at the expense of driving cash on cash returns which could have been earned by growing the portfolio company over a longer hold period
2. The standard 2% management fee rewards managers who build a large pile of AUM versus rewarding performance on the invested capital
3. The forced commitment period can encourage investors to deploy capital as the period draws to a close versus returning the funds if potential deals are not attractive enough

4. Over time and as a fund complex grows, the senior partners often receive a majority of the carry while junior team members are increasingly responsible for driving new deals and portfolio oversight
5. The standard GP was often earning in excess of 65-75% of their compensation from fees and carry versus on capital gains on funds they personally invested along-side the LP's
6. The lack of discretion allowed investors the opportunity to raise the fund and then creep into adjacent spaces over the five year commitment period without demonstrated expertise or experience in the new sectors

Combine these structural fund flaws with a recession, the availability of well-trained, hardworking private equity executives and an increasing desire for family offices, high net worth individuals and small institutions to regain control over their invested capital and the market was primed for a new hybrid model.

The chart below shows the major differences between the three private equity models:

	Traditional PE Fund	Independent Sponsor	Fundless / Broker
Fundraising	Every 4.5 years	Deal by Deal	Shop each deal to other firms
GP Investment	1-5%	5-20%	Limited; May roll a fee
Deal Sourcing	• Usually Industry Focused • Outbound calling / conferences • Likely participates in auctions	• Usually Industry Focused • Target deals directly • Rarely competes in auctions	Opportunistic; Will try to lock up deal and then find funding source
LP Issues	• Need to show returns prior to next fund raise may lead to premature sale of port. cos. • High fee content • Focus on IRR not CoC • LP has no discretion on each deal (style drift)	• Size of investments team • History of returns / expertise • Time needed to evaluate different deals versus making one decision to invest in a fund	N/A
Portfolio Management	• Can take a portfolio approach to overall fund returns • Find size may requre a broad approach with limited time to engage with each portfolio company	• Must actively work directly with management to improve operations • Companies are typically less sophisticated • GP needs to have broad experience	• None or limited
GP Pros	• Speed on closing a deal • Scale allows for resources	• Direct alignment with investors (discretion / returns) • CoC not IRR focused	• No substantial capital at risk • Fee driven model • Ability to handle multiple deals
GP Cons	• Time/Cost to raise a fund • Pooled/European Waterfall • Limited invetsment period may drive firm to invest rather than terminate LP's capital commitment	• Each deal must perform • More difficult to compete in auctions • Time to raise funds while doing diligence / legal • Broken deal expenses • Variable mgt fee inhibits adding staff	• Dependent on others to fund your deals • Limited ability to influence events/company • Limited upside

The independent sponsor model has gained traction since 2008. The best independent firms continue to adopt best practices like the more established PE firms and institutionalize their internal deal sourcing process and portfolio management techniques. Operating partners have gained confidence in the better independent sponsors and can move quickly to target industry verticals where their experience and background permit them to source proprietary deals. Recently, investment banks have become more accepting of independent sponsors that have a demonstrated record of raising the requisite funds needed to close deals under a letter of intent.

As a leading independent sponsor, we are excited and encouraged by these trends. We partner with strong family offices and institutions seeking the advantages of this new hybrid model.