

## Structuring Independent Sponsorship in M&A: Deal Terms

Management Fees, Promote and Carried Interest, Equity Return Hurdles, Sponsor and Fund Involvement Post-Closing

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Today's faculty features:

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# STRUCTURING INDEPENDENT SPONSORSHIP IN M&A: DEAL TERMS

PRESENTED BY

John Gilson  
and  
Michael Miller

**Moore & Van Allen**

## “STRUCTURING INDEPENDENT SPONSORSHIP IN M&A: DEAL TERMS”

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Management Fees, Promote and Carried Interest, Equity Return Hurdles,  
Sponsor and Fund Involvement Post-Closing

*A live 90-minute premium CLE video webinar with interactive Q&A*

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Wednesday, June 9, 2021

1:00pm-2:30pm EDT, 10:00am-11:30am PDT

*Presented by*

John Gilson

Moore & Van Allen PLLC

Michael Miller

Moore & Van Allen PLLC

# Part I

## Independent Sponsors: Background and Emergence

# Independent Sponsors: Background and Emergence

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Q: What is an Independent Sponsor (*a/k/a fundless sponsor*)?

A: You know it when you see it!

## Identifying Criteria:

- Individual or group of Individuals
- Seeking to acquire a company
- Do not have the equity financing needed for the transaction in advance (i.e., there is no committed fund behind them).
- Seeks out investors that can provide equity to acquire the target company
- Transactions tend to have enterprise values ranging from \$10-20 million on the low end to \$150-\$200 million on the high end

# Independent Sponsors: Background and Emergence

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- Growing presence in the lower-to-middle M&A market
- Increasing interest by co-investors with prominent or promising Independent Sponsors
- Sell-side advisers increasingly including Independent Sponsors in auctions and other competitive processes
- There are still nearly as many transaction types as there are capital partners (*i.e., market economics are highly dependent upon the Independent Sponsor's industry experience and track record, the investors and other financing partners involved, and the size of the transaction*)
- Economics differ from self-funded / traditional searcher deals, search fund deals, and privately financed management-led buyouts

# Part II

## Private Equity Fund Collaborations: Mutual Benefits

# Establishing the Relationship

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## Making Connections

- Former colleagues/clients.
- Fund managers keeping tabs on recent colleague, vendor or competitor departures.
- Networking events (*e.g.*, ACG)

## First Things First

- “So, I’ve got this deal...”
- Driving interest without giving the deal away
  - NDAs
  - Non-circumvention clauses
  - “Teaser decks”

# Benefits to Independent Sponsors

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## In Deal Making

- Added credibility in winning a deal with a reputable PE fund's backing
- Ability to leverage PE fund's industry knowledge for identifying hidden value
- PE fund contacts (e.g., lenders, RWI providers, vendors, etc.) may work with an Independent Sponsor when they otherwise wouldn't

## In Deal Execution

- Sometimes a one-stop shop for filling out the cap table
- Sounding board for diligence issues and negotiations (also a useful "empty chair" with some gravitas)

## Post-Closing

- Easier to fund bolt-on acquisitions
- Reputable source for giving references for next deal (or fund)
- Potential source of capital for next deal (or fund)

# Benefits to Private Equity Funds

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## Deal Flow

- Lots of dry powder, fewer worthy targets
- Lower sourcing and diligence costs
- Exposure to assets that may normally fly under a PE fund's radar but hold significant value (*e.g.*, proprietary deals, less mature companies with larger growth potential, etc.)
- Ability to take or pass on a deal-by-deal basis

## Fund Manager Diligence

- Potential for larger future equity checks on Independent Sponsor deals or fund-of-fund investment
- Future acquisition target opportunities

# Post-Closing Interaction

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## Governance

- Rights depend on nature of sponsor and PE fund investor
  - Some PE investors want only advisory board or board observer rights
  - Some PE investors want to control the board
- Independent Sponsors should determine before partnering with a PE fund whether they want a silent partner or a boss and establish the expectation early
  - Easy for an Independent Sponsor to lose control of an investment with a single PE fund backer
  - Consider the cap table to prevent outsized influence of one PE fund
  - Reporting requirements may erode the benefits of a fund-less model
- Operating partners, strategic experience and industry contacts can help drive value and operational efficiencies.

## Exit

- Governing documents will usually establish a PE fund's role in determining an exit (e.g., forced sale right, exit veto, etc.)
- PE funds can be helpful on the cap table/board to show expertise in managing and growing the business – PE fund's reputation can be indicative of a clean company or high-potential asset, thus driving higher exit price.

Part III  
Issues to Address in the  
Sponsorship Agreement and  
Governance Documents

# The Investor / Independent Sponsor Relationship

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## Sponsorship Agreement

- Investor / Independent Sponsor relationship frequently begins with a sponsorship agreement (often in the form of a memorandum of understanding (MOU) or indication of interest (IOI))
- Distinguish between arm's-length Independent Sponsor structures with one disproportionately large institutional investor vs. a broader “*pass the hat*” investor base
- The Sponsorship Agreement is typically non-binding but:
  - gives the Investor **exclusivity** on the funding rights to the deal; and
  - gives the Independent Sponsor **non-circumvention** protections which restrict the Investor from negotiating directly with the target company
- The Sponsorship Agreement typically sets forth the **investment size**, any **splitting of fees**, relative **equity stakes**, and business terms such as the **management fee**, **promote / carried interest** provisions, the **closing fee** payable to the Independent Sponsor and any agreed upon **expense reimbursements** (*i.e., the Independent Sponsor’s legal and accounting fees*)
- The Sponsorship Agreement may also set forth a list of the specific rights required by the investors to approve actions by the company (also called “**protective provisions**”). Which protective provisions are customary is dependent upon whether there is one large investor with a disproportionate amount of the equity or several similarly sized investors.

# Management Agreement: Management Fee

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## Amount

- 3% to 5% of target EBITDA (earnings before interest, taxes, depreciation and amortization)

## Payment

- Typically paid quarterly in arrears and tested on a trailing 12-month basis during the term of the underlying management agreement

## Caps / Floors

- Often subject to a hard dollar floor and cap (*e.g.*, \$250,000 to \$750,000 with outliers on the upper end for high-potential, well-connected Independent Sponsors with track records)
- Management fees payable to less experienced Independent Sponsors are more often subject to smaller caps and no floor

# Management Agreement: Closing Fee

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## Closing Fee

- The closing fee of 1% to 5% of enterprise value (EV) is often subject to a hard dollar cap and floor.
- However, depending on the investor base, this fee may be rolled into the Independent Sponsor's equity investment in the portfolio company.
- Federal and state securities laws may, however, affect certain Independent Sponsors' ability to accept success-based transaction fees.
- The market for economic and deal terms in smaller micro market M&A transactions is still very much the wild west due to varying degrees of expertise of sellers, their advisers and other market participants.

# Management Agreement: Other Notable Terms

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## Time and Attention

- Required to devote a specified amount of business time and attention to the portfolio company.
- Ranges from (1) the time and attention reasonably necessary to satisfactorily perform the management services to (2) a majority or *substantially all* of the Independent Sponsor's business time and attention.

## Other Activities

- The Independent Sponsor is generally prohibited from engaging or investing in any outside activities that directly or indirectly compete with the portfolio company.
- Additional requirements may be imposed on the Independent Sponsor's conduct of the business depending on the deal and any special requirements of the equity or debt financing partners, such as leverage limitations.

## Expense Reimbursement

- The Independent Sponsor is generally entitled to reimbursement for a negotiated list of “reimbursable expenses” related to the performance of the management services.

## Promote Forfeiture

- If the Independent Sponsor experiences a “for-cause” termination or disassociation without “good reason”, the management agreement is typically terminable.

# LLC / LP Agreement: Promote/Carried Interest

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## Summary

Both the Independent Sponsor and the institutional investor agree to (1) a 10% to 20% carry for the institutional investor tied to a 1 times to 2.5 times multiple of invested capital (MOIC); (2) an 8%, accruing, not compounding, preferred return for the preferred equity; and (3) a catch-up for the institutional investor.

## Market Carry

- Ranging from a base of 10%, the carry increases to a maximum of 20% to 30% carry upon the achievement of certain financial hurdles.
- From the 10% base, the carry typically increases according to thresholds and hurdles such as those set forth below:
  - First, a 10% to 15% carry above 1 time to 2 times MOIC, and 8% preferred return;
  - Then, to a second-tier carry of 15% to 25% above a 2 times to 2.5 times MOIC and 8% preferred return; and
  - Finally, to a residual, third-tier carry of 20% to 30% above a 2.5 times to 3 times MOIC and 8% preferred return.\*\*
  - ***\*\*Note: A carry in excess of 20% is often reserved for more experienced Independent Sponsors or Independent Sponsor transactions with a broad "friends and family" investor base.***

## Catch-Up Provision

- To further incentivize stellar performance, investors will often allow Independent Sponsors to benefit from a catch-up provision.
  - ***Note: A "catch-up" provision is a mechanism in the waterfall that catches the Independent Sponsor up to the applicable percentage to be received by the Independent Sponsor in the next step of the waterfall***

# LLC / LP Agreement: Sample Waterfall

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## Sample Waterfall

Below is a sample waterfall based on a hypothetical transaction where the Independent Sponsor raises \$30 million of preferred equity from its investors (the preferred holders):

Step 1: Payment of the accrued and unpaid preferred return (8%) to the preferred holders;

Step 2: Return of capital to the preferred holders (i.e., a one-time liquidation preference on invested capital (\$30 million));

Step 3: Payment of all remaining amounts (subject to the Promote / Carry below) to the preferred holders and to common holders based on the number of units held;

## Promote / Carry:

Step 3A — **(catch-up)** Payment to the Independent Sponsor until the Independent Sponsor has received 10% of the amounts received by the investors in excess of their invested capital;

Step 3B — 90% to the preferred holders and 10% to the Independent Sponsor until the preferred holders have received an aggregate amount equal to two times (2x) their invested capital (\$60 million);

Step 3C — **(catch-up)** Payment to the Independent Sponsor until the Independent Sponsor has received 15% of the amounts received by the preferred holders in excess of their invested capital;

Step 3D — 85% to the preferred holders and 15% to the Independent Sponsor until the preferred holders have received an aggregate amount equal to two and one-half (2.5x) its invested capital (\$75 million);

Step 3E — **(catch-up)** Payment to the Independent Sponsor until the Independent Sponsor has received 20% of the amounts received by the preferred holders in excess of their invested capital; and thereafter

Step 3E — 80% to the preferred holders and 20% to the Independent Sponsor.

# LLC / LP Agreement: Sample Waterfall

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## Sample Protective Provisions

The investor's consent (or the consent of the investors holding a majority of the investor equity) is typically required for the company or a subsidiary to:

- ***(Very Typical Rights - customary protective provisions which are in most deals)***
  - Enter into non-arm's length related party or affiliate transactions
  - Make non-pro-rata redemptions of equity
  - Change the size, composition or powers of the Board
  - Increase the size of the incentive equity pool (which is typically capped at 10% of the fully-diluted equity)
  - Create or hold the equity interests of any subsidiary that is not a wholly-owned subsidiary
  - Amend the governing documents in a manner *[materially]* adverse to the investors
  
- ***(Less Typical Rights - protective provisions which are less common but frequently requested)***
  - Incur debt
  - Issue or authorize a class of preferred senior *[or pari passu]* to the investor equity
  - Consummate change of control transactions (i.e., acquisitions, mergers, etc.) or liquidation events
  - Hiring, firing, and setting compensation or terms of employment of key management
  - Setting annual budgets and making any material unbudgeted investments, dispositions, or expenditures
  - Changing the strategy or principal lines of business of the Company

# LLC / LP Agreement: Sample Waterfall

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## Equity Vesting

- Most often, Independent Sponsor equity is not subject to vesting
- If required, vesting is time-based over a three-year to five-year period

## Promote Forfeiture

- If the Independent Sponsor experiences a “for-cause” termination or disassociation without “good reason”, accrued and unpaid promote is generally forfeited

## Board Composition

Ranges based on the make-up of the investor group:

- Where there is one disproportionately large investor, it is typical for board control split between the that investor and the Independent Sponsor with an independent director appointed to be the tie-breaking vote to the Independent Sponsor
- Where there is no one disproportionately large investor, it is typical for board control held by the Independent Sponsor or, sometimes, there is no true board at all, and the investors are offered seats on a non-fiduciary / non-voting advisory board

# Conclusion

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- The Independent Sponsor market is still in the early stages of maturation. We anticipate that investor allocations to Independent Sponsor transactions will continue to grow and that the market will mature, generating standardized terms and best practices, in much the same way that the private equity industry matured over the last few decades
- No one-size-fits-all deal structure or standardized set of investment terms, however the Independent Sponsor market is beginning to develop some uniformity in lower middle market transactions
- Every deal is different, and its structure depends dramatically on the pedigree of the Independent Sponsor, the uniqueness of the opportunity — including the perception of valuation relative to the market — and the sophistication and appetite of the investor base
- Deal-structuring and negotiation is complicated by the unique nature of each Independent Sponsor transaction
- The Independent Sponsor model is an attractive alternative to conventional private equity and is open to institutional investors, family offices and high-net-worth individuals alike - ***increasing amounts of capital can be anticipated to court these investment professionals***