EIGHT STEPS FOR A SUCCESSFUL INDEPENDENT SPONSOR TRANSACTION

1. IDENTIFY A TARGET COMPANY THAT CAN BENEFIT FROM YOUR SKILL SET

An all-too-often overlooked key element for a successful independent sponsor transaction is the match between the target company's business and the Independent Sponsor's competencies. Finding a company to which the Independent Sponsor can bring some value is an essential component to ultimate success. Such value can come in the form of developing a more formal strategic plan for the business at the board level, to assuming the role of the CEO. A Sponsor's degree of involvement can, and does, vary greatly depending on a number of variables (which are discussed in a subsequent section). What must be determined first is whether or not the company's industry and operations are something the Sponsor can help grow and improve. For example, if a sponsor who has spent his career in the consumer products space finds a home builder that can be acquired at an attractive purchase multiple, it may not be a good opportunity notwithstanding the price. Or, it may indicate the Sponsor should seek a capital provider or operating partner with experience in the construction industry to augment the general management and strategic planning capabilities the Sponsor brings to the transaction.

2. ENSURE COMPATIBLE OBJECTIVES BETWEEN YOU AND THE SELLER

Most independent sponsor transactions are completed in the lower middle market (i.e., companies with enterprise values less than $100 million). Transactions in this segment are quite often with family-owned businesses that are seeking some form of liquidity for such life cycle reasons as retirement, estate planning, stock buybacks, divorce, death, etc. Accordingly, transaction objectives for family-owned businesses seeking liquidity can, and are, quite varied. This reality requires the Independent Sponsor to thoroughly understand not only the monetary goals of the seller(s), but just as importantly, the seller(s) non-monetary goals, including post-closing management involvement expectations, desired residual investment/ownership level, impact on the company's employees, future roles for other family members involved with the company, and comfort level with planned changes to the business. These intangible objectives are probably as important to the seller(s) as the financial considerations, but are quite often given insufficient attention early on in the transaction process, leading to major issues later, and in some cases, even resulting in the termination of deals due to irreconcilable differences over such issues. Therefore, an Independent Sponsor must develop a comprehensive understanding of the seller(s) desires before drafting and entering into an LOI.

3. DEFINE AN APPROPRIATE MANAGEMENT ROLE FOR YOU POST-CLOSING

Independent Sponsors span a wide spectrum in terms of their preferred involvement in a company post-closing. Financial-oriented sponsors generally prefer board oversight roles, while operationally-oriented often look for management roles, even assuming the CEO in some cases. In the middle, are sponsors who look for temporary management involvement for the time needed to institute some structural changes to the business, such as installing a new I.T. system or overhauling the management team. As mentioned in a previous section, Independent Sponsors ideally seek to invest in companies that allow them to bring some value-added involvement to the business, whatever that may be. To best ensure a seamless transition to the new ownership and management structure post-closing, the Independent Sponsor must thoroughly and unambiguously define their future role in the company so that the seller(s), existing management team members and the capital providers are all have the proper expectations. Loosely-defined post-closing roles for the Independent Sponsor can create undue anxiety with the current management team and have a negative impact on the capital provider community when assessing the investment opportunity. Therefore, both for the sake of transition management and attracting the best possible financing, the Independent Sponsor needs to invest the time to carve out and articulate a role for himself that is credible relative to the experience he brings to the transaction.

4. STRUCTURE AN LOI THAT ALLOWS FOR SUCCESSFUL CAPITAL SOURCING

Based on over twenty years of doing independent sponsor deals, we can say we full confidence that transaction complexity is negatively correlated to transaction success. In other words, the more engineered the deal structure, the more likely it is a capital provider will find a reason to say no. However, in an effort to get an opportunity under exclusive LOI, Independent Sponsors often find themselves in situations where they are going "off script" and agreeing to provisions in an LOI that make financing the transaction harder, or even impossible. Once poor terms are agreed to, it is typically difficult to unravel them with the seller, thus putting the transaction on thin ice. The best way to avoid such situations is to engage your preferred capital provider early in the LOI negotiation process to prevent "gotcha" provisions that render an otherwise fairly-priced and structured opportunity non-financeable. This approach often provides the additional benefit of making an Independent Sponsor's LOI more competitive if the capital provider is willing to jointly issue the LOI or allow it to be cited as the financing source within the LOI.

5. DEFINE YOUR ECONOMICS—FEES, EQUITY PARTICIPATION, ETC.

Independent Sponsor economics vary enormously depending upon a number of variables such as deemed purchase price attractiveness, ability to add value post-closing, willingness to bear due diligence costs, transaction exclusivity, etc. Most of these variables are intangible so arriving at acceptable sponsor economics is always a negotiation with one's capital provider. In our experience, we have found these conversations go best when the Independent Sponsor has generally defined their preferred economics, but are also open to alternatives suggested by the capital provider. Requests for excessively high economics is not typically a successful tactic as many capital providers do not have the time to overly negotiate such terms, so they may pass on an otherwise attractive opportunity. We believe the best approach is to develop a general understanding with your preferred capital providers about acceptable sponsor economics prior to discussing a particular opportunity. Then, when a transaction is being pursued, you can begin your discussions with your capital providers within an already mutually understood framework, making adjustments as the specifics of the transaction dictate.

6. SELECT THE "RIGHT" CAPITAL PROVIDERS—COST IS NOT THE ONLY CRITERIA

Other than identifying a target company to invest in, the most important decision an Independent Sponsor makes during a transaction is picking his capital providers, especially his junior capital providers (i.e., junior debt and equity). Many capital providers have recently begun reaching out to Independent Sponsors, after largely ignoring them for years. This new found favor is positive for Independent Sponsors in terms of having a greater universe to which to market their transactions; however, it also makes comparing financing proposals more of a challenge. Cost of capital is, of course, very important and is the easiest feature to compare across financing proposals, but it is far from the only variable that matters. Given the enormous time and effort an Independent Sponsor invests to get a transaction to the LOI stage—not uncommonly a year or more—it is critical the chosen capital provider has the experience, ability and competence to close your deal. In addition, will the capital provider attempt to work through the inevitable setbacks that occur during the due diligence process, or will they abandon the deal at the first sign of trouble? Financing Independent Sponsor deals is a true specialty that involves subtlety and finesse more traditional buyout deals do not. An Independent Sponsor needs to understand that financing in this segment of the market is not a commodity and cost of capital is but one of a myriad of considerations that must be weighed prior to selecting a capital provider.

7. CREATE A JOINT DUE DILIGENCE AND CLOSING PLAN WITH CAPITAL PROVIDERS

Once an Independent Sponsor has selected his capital providers, it is important to create a formal due diligence plan and schedule, including identifying which party is responsible for which costs. Typical deals require hundreds of thousands of dollars be spent of accounting, legal, environmental, insurance and other consultants. Selecting and managing these consultants is vital to a timely and cost-effective outcome. Too often the selection and responsibility for these consultants is not coordinated well, resulting in misunderstandings amongst the transaction parties, and inefficiencies that can cost time and money.

8. DEVELOP A POST-CLOSING PARTNERSHIP WITH CAPITAL PROVIDERS—CLOSING IS THE BEGINNING, NOT THE END

Congratulations! You have closed your Independent Sponsor deal. Hundreds, if not thousands, of man-hours went into closing the transaction, but now what? Our experience has shown us clearly that the Independent Sponsor must work to establish open lines of communication from the outset to promote proper corporate governance and investor transparency. By doing so, goodwill and trust are built with capital providers that are critical to navigate any operational challenges that may arise, and to chart a course for the company through eventual exit that all parties support. Regular and professionally run board meetings, timely and accurate financial reporting and prompt responses to questions about the business are vital to developing the sort of supportive relationship an Independent Sponsor needs with his capital providers to be successful in the long run. As the saying goes, "You only get one chance to make a first impression." Therefore, establishing strong communication and reporting regimens at the very beginning of an investment, sets an important tone that will help the company, and Independent Sponsor, in the months and years to come.

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