Session 3: Financing Independent Sponsors – Issues and Approaches for Providers of Junior Capital

11:00- 12:00 PM

Moderator: Stuart Chasanoff, *Of Counsel, Dorsey & Whitney LLP*

Panelists:
Jason Block, *Partner & Chief Investment Officer, Freedom 3 Capital*
Jeffrey Holland, *Partner, Seacoast Capital*
Brian R. Kerr*, Managing Director, ORIX Mezzanine & Private Equity*
Jamie Whatley, Partner, Dorsey & Whitney LLP

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Wednesday, September 27, 2017

Selected Issues in working with Independent Sponsors - Outline

I. Why work with Independent Sponsors?

A. Evolution of role that Independent Sponsors play in the private equity market.

1. Originally “finders” – locate opportunities but little additional value added – or deal professionals who had failed a raising a fund for one reason or another.

2. “Modern” Independent Sponsors can bring more value to the table:

a. Deal sourcing; relationships with owners that might be under the radar for larger funds;

b. Industry expertise that financing sources may lack

c. Particularly for institutional LPs, Family Offices and HNWs that want to make direct investments, an investment team that can underwrite, perform due diligence, manage transaction and provide post-closing oversight.

3. “Modern” Independent Sponsors:

a. PE professionals who have left “funded” sponsors

(1) Tired of fund-raising process

(2) Path to partner at “funded” sponsor is unclear/blocked

(3) Desire to focus on lower middle market

b. Experienced executives

(1) May have cashed out once or twice in PE-backed deals

(2) Deep knowledge of industry participants and dynamics

c. Successful entrepreneurs

(1) Typically have successfully built and exited companies

(2) May have industry knowledge similar to executives; also have proven track record of commercially viable product or service development

4. Plenty of cash available for investment; scarcity of attractive deals

5. Rise of "mega-funds" with (perceived) higher costs resulting in institutional LPs searching for more direct investment opportunities.

6. Increasing role of Family Offices – while many invest in traditional PE funds, Family Offices often find working with independent sponsors provides transparency and better economics.

7. A non-scientific survey showed at least a half-dozen 2017 conferences that focused, primarily or partially, on independent sponsors.[1]

B. What types of Investors are working with Independent Sponsors?

1. "Funded" Sponsors (credit funds, mezzanine funds, SBIC's, BDC's, PE funds)

2. Family Offices, HNW

3. Institutional LPs

4. Investment Advisers; Managed Accounts

5. Financial Services Companies

II. Economics of Independent Sponsor Deals

A. Closing Fee

1. 1% to 5% of Enterprise Value

2. Inversely related to Enterprise Value

3. Independent Sponsors typically want to roll all or a portion of their closing fee into equity

[1] Capital Roundtable; iGlobal; Opal Connect; Emerging Manager Connect

a. Rolling closing fee into equity presents tax-related issues that are beyond the scope of this presentation.

B. Ongoing Management Fee

1. Fixed annual fee

2. Percentage of EBITDA

a. Usually between 3% and 7%

b. Inversely related to projected EBITDA

c. How is EBITDA calculated?

(1) Note that investor may be supporting Independent Sponsor position regarding EBITDA add-backs in negotiations with lenders, and arguing against some or all of those add-backs in negotiating management fees.

3. Hybrid: Percentage of EBITDA, with a fixed dollar amount floor (and perhaps a fixed dollar amount cap)

a. Anecdotally, hybrid management fees seem to be the norm.

4. Expense Reimbursement

C. Carried Interest/Promote

1. Simple: Independent Sponsor receives a percent of profits after investors receive return of capital plus a preferred return (usually 8%-10%).

2. Tiered Promote: Independent Sponsor receives an increasing share of profits (usually 10% to as much as 25%) based on investors' returns.

a. Multiple of Invested Capital

b. IRR or other measure

D. Transaction Fees

1. Independent Sponsors often request fees for future transactions (acquisitions, financings, exit, etc.)

2. Viewed as neutral to negative by funds and institutional investors that finance Independent Sponsor deals; may be more palatable to Family Offices and HNW.

3. From the standpoint of the Independent Sponsor, receipt of transaction fees can present regulatory issues if the Independent Sponsor is not a registered broker dealer[2] and does not satisfy the exemptions from broker dealer registration described in the SEC's M&A Broker No-Action Letter.[3]

III. Key Terms & Issues – Debt

A. Management Fee

1. Funded sponsors are pushing for a more limited set of defaults to block management fees (expenses often time are outside of the block)

2. In an Independent Sponsor deal, the block for management fees is more restrictive (typically occurs upon any Default or Event of Default and expenses are often times subject to the block)

B. Default Rate

1. Sponsors are pushing for the Default Rate to only be charged on a "Specified Event of Default" (bankruptcy, financial covenant and failure to delivery financial statements/compliance certificate) and for the Default Rate to only be charged on the overdue obligations.

2. With Independent Sponsors, typically the Default Rate can be charged for any Event of Default and can be charged for all outstanding Obligations.

C. Grace Periods for Events of Default

1. Lenders are generally more lenient for Funded Sponsor deals than for Independent Sponsor deals

D. Negative Covenants

1. Baskets, carve-outs, Permitted Acquisitions: Lenders are generally more lenient for Funded Sponsor deals than for Independent Sponsor deals

IV. Key Terms & Issues – Equity

A. Independent Sponsor Deal Dynamics

1. Relationship with Owner/Seller; How are terms/definitive documents drafted, approved, negotiated?

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[2] *See* In the Matter of Blackstreet Capital Management, LLC and Murry N. Gunty (Release No. 34-77959, June 1, 2016).
[3] *M&A Brokers* SEC No-action Letter, 2014 WL 356983 (Jan 31, 2014).

2. Investor group/Independent Sponsor's "skin in the game"

3. Selection/instruction of Advisers and Consultants

B. Governance/Control/Negative Control

1. Governing board dynamics

a. Board members vs. observers

b. Fiduciary Duties

2. If Independent Sponsor controls portfolio company, can it be removed and under what circumstances?

a. "Bad Actor"

b. "Key-person" type events

c. Minimum ownership/investment threshold

3. "Negative Control"/Consent Rights

C. Independent Sponsor Compensation/Rollover Equity/Incentive Compensation

1. See Item II above.

2. Suspension of management fees based on performance targets

3. Term and termination of management fee agreement

4. Limits and caps on expense reimbursement

a. Independent Sponsors typically do not have the same conflicts of interest and expense allocation issues that have brought scrutiny on Funded Sponsors.

D. Exit Mechanisms

1. Put/Call and Redemption Features

2. Co-Sale Rights (drag-along; tag-along)

3. Sale Process

Stuart Chasanoff, *Of Counsel, Dorsey & Whitney LLP*

Stuart focuses on providing clients with practical, results-focused services and expert advice and counseling that enable clients to achieve their business goals on a cost-effective and timely basis. He brings over two decades of combined experience in major, multinational law firms and as in-house counsel to FTSE-100, Fortune 25 and small public companies, private companies, family offices and investment management firms to his practice.

Stuart represents a wide range of private equity and mezzanine funds, independent sponsors and institutional investors in fund formation, acquisitions, growth and exit transactions, control and minority equity investments and all manner of domestic and cross-border mergers, acquisitions and divestitures. He also counsels fund portfolio companies, start-ups and other privately held business on entity formation and governance and a broad range of business and operational matters.

Jason Block, *Partner and Chief Investment Officer, Freedom 3 Capital*

Jason Block is the Founding Partner and CIO of the Manager and has more than 20 years of experience investing in private credit and equity. Mr. Block became actively involved in investing private credit and equity in 1995 and has managed private investments in over 50 companies.

Prior to Freedom 3, Mr. Block was the founding Partner of ICG's North American investment business. Mr. Block led the newly created North American business on seven investments for over $300 million of invested capital. Also while at ICG, he was the Partner responsible for building ICG's global Investor Management Group focused on fundraising, communication and other investor matters for all of ICG's products on a global basis. He set the mandate for the Investor Management Group and grew the team from two people to 13 professionals covering over 250 investors worldwide.

Prior to ICG, Mr. Block was a Partner at AlpInvest where he was responsible for founding and building their global mezzanine platform. During his six years at AlpInvest, he led the team in 27 investments for nearly $500 million of invested capital.

Before AlpInvest, Mr. Block worked as a Portfolio Manager for Caravelle, an affiliate of CIBC, where his responsibilities included investing in mezzanine, private equity and high yield. Prior to joining the Caravelle team, he was a Managing Director in CIBC's Leverage Finance/Sponsor Coverage group. Mr. Block started his career as an investment banker for Kidder, Peabody.

Mr. Block is a member of the Advisory Panel to the Atlantic Conference on Mezzanine & Middle Market Symposium. He has also been an observer or director on the Board of over 20 companies during his career.

Mr. Block received his BA in economics from Colgate University, graduating *magna cum laude*.

Jeffrey J. Holland, *Partner, Seacoast Capital*

Mr. Holland co-founded Seacoast Capital, which invests $5 to $20 million of non-control debt and equity growth capital in middle market companies, in 1994. Previously, Mr. Holland was a Senior Investment Manager of Signal Capital and opened the San Francisco office in 1989. Prior to joining Signal Capital in 1987, Mr. Holland was a consultant with The MAC Group, Inc., where he worked on strategy engagements in the financial services industry, and Andersen Consulting. In addition to serving on the boards of several Seacoast and Signal Capital portfolio companies, Mr. Holland is a past member of the Board of Governors of the Small Business Investor Alliance (SBIA), a member of the Advisory Council and past Chairman of the Board of the Harvard Business School Association of Northern California, and a past director of the San Francisco Association for Corporate Growth. He received a BS in Industrial Engineering from Stanford University and an MBA from Harvard Business School.

Brian Kerr, Managing Director, *ORIX Mezzanine & Private Equity*

Brian Kerr is a Managing Director of ORIX Mezzanine & Private Equity. Mr. Kerr has spent 19 years working with lower middle market corporations and entrepreneurs on financial and strategic projects, including balance sheet recapitalizations, debt and equity alternatives, leveraged buyouts, and mergers and acquisitions. Prior to joining ORIX USA, Mr. Kerr was the founder of Clairemont Capital Group, a lower middle market private investment firm. Before forming Clairemont Capital Group, Mr. Kerr was a Managing Director at Cornerstone Capital Holdings and Penn Mezzanine. At both Cornerstone and Penn Mezzanine, Mr. Kerr was responsible for sourcing, evaluating and underwriting investment opportunities, as well as portfolio company management. Mr. Kerr started his career as an investment banker advising private and public companies on M&A, private placement and equity and equity-linked transactions.
Mr. Kerr received his Bachelor of Science in Economics from Lehigh University and MBA from The Fuqua School of Business at Duke University.

Jamie Whatley, *Partner, Dorsey & Whitney LLP*

Jamie represents a variety of corporate finance clients in finance transactions and debt restructurings.

She represents financial institutions, private equity funds, mezzanine funds, agent banks, institutional investors and startup companies in finance transactions and debt restructurings. Her experience includes both senior and subordinated debt transactions, leveraged buyouts, second lien financings, unitranche financings, cash flow and asset-based financings, equipment financings, project financings, structured financings, health care financing and real estate financings. She also has extensive experience in workouts and restructurings.

Jamie has handled corporate transaction matters across a wide range of industries, including energy, financial services, manufacturing, telecommunications, technology, transportation, insurance, retail, health care, construction, restaurant and hospitality.