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NEWS & ANALYSIS

The case for independent sponsor deals amid covid-19

Lower entry multiples in the small-cap segment and more companies that are open for takeover discussions add to dealflow

The coronavirus pandemic is creating opportunities for deal-by-deal or independent sponsors, according to a report from London-based small-cap investor Co-Investment Partners.

According to the firm's No Fund, No Problem report, opportunities for independent sponsors will come from a bigger hunting ground for add-on acquisitions. Further, the fact that independent sponsors hold a smaller number of portfolio companies that need troubleshooting leaves them more time for fresh acquisitions.

For LPs looking to back deal-by-deal managers, the main advantages are more control, flexibility and cost efficiency as they seek to mobilise capital in a downturn, Hanspeter Bader, founding partner at Co-Investment Partners, told Private Equity International.

In a downturn, where LPs are generally more "risk off", deal-by-deal transactions can provide more certainty and transparency than a blindpool fund with a pipeline that has yet to be built up, according to Bader.

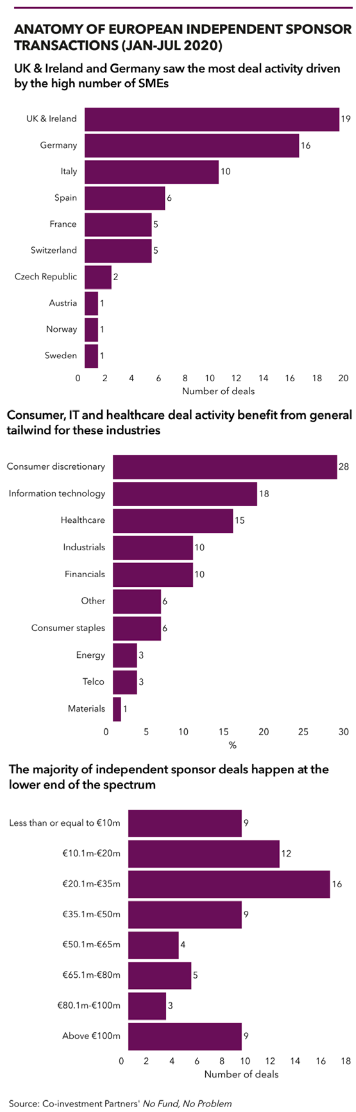
"The fact that investors know upfront what they are committing capital to makes it much easier for either a yes or no," he said, adding that independent sponsors are also in a "luxury position" to be more flexible in terms of deal size and deal type when opportunities arise from market dislocation.

Market participants the firm spoke to for the report revealed they expect acquisition multiples to come down as the "new reality" has settled in, with a reduction in EBITDA multiples by 1x-2x. However, this might not be true for sectors including internet, software and pharma, which generally provide solutions in the context of reduced social interaction and have fared well in the environment, the report noted.

Along with lower entry multiples, there are more companies on the brink of bankruptcy due to the impact of covid-19 that are open for takeover discussions, according to the report.

"For market-leaders with strong financial backers and low or no leverage, there will be outstanding acquisition opportunities or the possibility to take over the client base of a struggling competitor," the report noted.

Younger independent sponsors will also have fewer assets to trouble shoot at this time, than an established fund with three funds of around 20 to 25 companies to look after, thus leaving more time for deal sourcing.



While nimbleness and flexibility help independent sponsors in a market downturn, challenges remain. The slowdown in deal activity is hitting younger independent sponsors with only a couple of deals in their portfolio. Deal financing has become challenging as banks are in a "risk off" mode with resources being absorbed by government support schemes, the report noted. Having an underperforming first or second deal that is hard-hit by the health crisis might also be an obstacle to raising capital for future deals.

Comparing the US and Europe, Stephan Seissl, a founding partner at CIP, noted that the deal-by-deal model is still nascent in Europe, which could be due to the region's fragmented local markets and investor groups favouring their home markets. "Capital raising for single deals needs to go fast. Frontiers, different languages and different legal, structuring and tax requirements don't make things easier," Seissl said.

Anecdotal evidence and research by CIP indicate 400-500 independent sponsor groups in the US are responsible for about a quarter of private equity deals in the US. In Europe, independent sponsor groups number more than 140.

Seissl noted that although appetite from PE professionals to become independent sponsors needs more time to evolve, a downturn could bring about more players into the market.

"I think we will see more people in the next two years who will take the opportunity and dare to jump ship now and go it alone, partially because it's frustrating today to mainly deal with troubleshooting portfolio companies rather than doing new deals."

Carried interest being pushed back as investment horizons stretch out due to the impact of covid-19 will also play a part in this dynamic, he added. ■