YANA INVESTMENT PARTNERS

Insight

Tailwind in rough waters

Deal-by-deal investing in a challenging market environment

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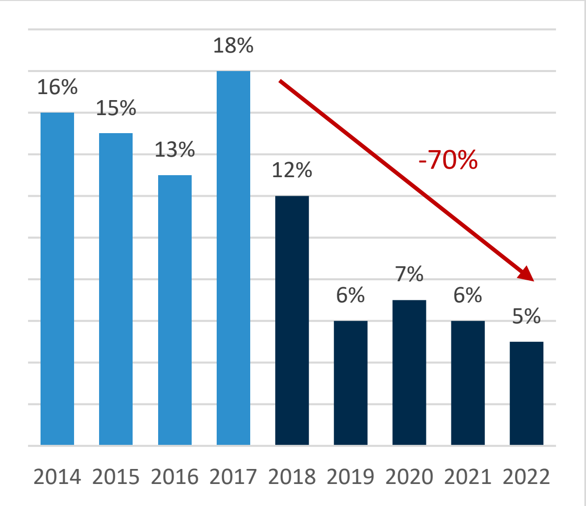
Introduction

In the last couple of years, the environment for private equity investing has changed radically: rising interest rates, inflationary pressure, recession fears, volatile stock markets and geopolitical tensions impacted deal closing, complicated debt financing, substantially reduced the amount of exits and made fund raising for private equity funds more difficult.

Figure 1: First time managers private equity capital raising as % of total[1]



Despite this challenging environment or, as we will show below, because of this challenging environment, raising capital and investing on a deal-by-deal basis has gained traction, especially in Europe, where the deal-by-deal approach is not yet as advanced as in the US market.

According to a study by Triago, USD 31 billion were invested globally on a deal-by-deal basis in 2023, which is five times more than in 2019.

Below we provide explanations for the increasing importance of deal-by-deal investing and highlight attractions as well as challenges of this approach in the current environment.

Fund raising challenges for emerging and first-time managers

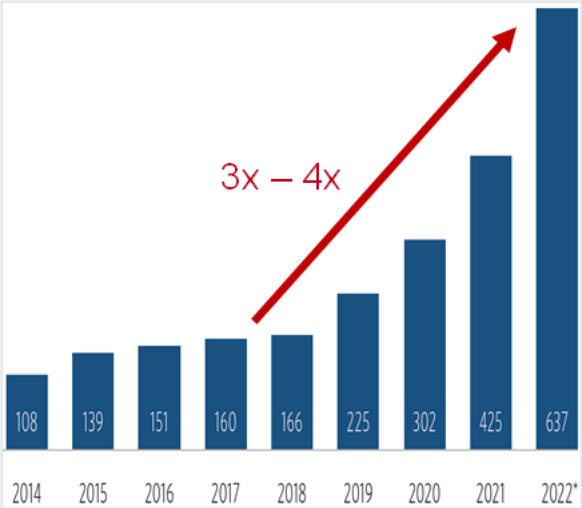
In challenging times, investors commit less to private equity because they become more risk averse, want to preserve cash and favour liquidity or at least liquid assets over illiquid private equity investments. Private equity fund raising has therefore been challenging over the last years, even for reputable private equity firms. Emerging and first-time fund managers without an established network of investors, and often considered "riskier" than brand-name firms, were hit hardest. *Figure 1* shows that the global share of capital raised by first-time fund managers dropped by approximately 70% since Covid and stayed at record low levels ever since.

Over the same period, the time to raise a private equity fund increased substantially. *Figure 2* shows that the number of funds which have been in fund raising for more than two years multiplied by 3-4x from 2018 to 2022.

[1] McKinsey Global Private Markets Review 2023

Cover picture attribution: Vecteezy.com

Figure 2: Funds open for more than two years, global[2]



Realising entrepreneurial ambitions

Based on our own experience across several private equity cycles, and somewhat counter-intuitively, more new private equity managers are set up through spin-offs from established firms in challenging times than in a more benign economic environment. Talented professionals in the private equity industry often feel the desire to build their own firms. Frustrated by increasing hierarchy, organisational bottlenecks, (unsuccessful) bidding in auction processes and dealing with investment bankers rather than with entrepreneurs, many senior people seek to leave their comfortable employment role and start their own entrepreneurial venture. "Back to the roots" is an expression we hear often from new private equity teams.

The opportunity cost to start a new private equity firm might be lowest in a challenging environment: The foregone carried interest is lower if fund valuations drop, the prospects for a promotion to senior partner are more limited and the investment and exit activity is subdued.

A growing universe of "independent sponsors"

The combination of a challenging fund-raising environment for first-time managers and the unbroken formation of new emerging private equity firms leads to the formation of more and more deal-by-deal sponsors or, as they are typically called, "independent or fundless sponsors". Rather than wasting several years trying to raise a first fund with uncertain outcome, many (if not most) new private equity teams nowadays turn the process upside down: First do deals, build a track record and an investor base and only later, possibly, raise a fund. More established in the US, this approach has gained traction in Europe since we first started investing in independent sponsor transactions nearly seven years ago.

Most independent sponsor firms start off with two to three partners and a couple of associates or investment directors. They execute approximately one deal per year, invest substantial own capital in every transaction and, without any legacy investments, can fully focus on their single transactions. Given their ambition to build a new private equity firm, their first transactions must be successful. Alignment with their investment partners is therefore higher than in most other segments of the private equity universe.

Certain independent sponsors have developed the deal-by-deal model so successfully that they do not need to raise a traditional closed-end private equity fund anymore but can continue growing as "fundless sponsors". Penta Capital in the UK and Cleon Capital in Spain are examples of such firms.

[2] McKinsey Global Private Markets Review 2023

Attractions of the deal-by-deal model

Capital providers in deal-by-deal situations are typically relatively sophisticated private equity investors like large family offices, institutions (mainly in the US), occasionally secondary funds to create additional upside potential or co-investment funds to get exposure to small-cap transactions.

Yana Investment Partners is, to our knowledge, the only European private equity firm, focusing exclusively on partnering with independent sponsors.

We believe that done right, deal-by-deal investing is especially attractive in the current challenging market environment:

"Cherry picking"

Committing to a traditional closed-end private equity fund entails "blind pool risk": A fund commitment is based on trust and the hope that the managers will do what they said when they were fund raising. Especially with first-time managers this requires a certain leap of faith. Working with independent sponsors, however, means working on one identified company, with knowledge about the sector, the management, the competition, its growth characteristics etc. Deal-by-deal investing therefore allows cherry picking and building a "tailor made" portfolio. Over the last 3 years, Yana has focused on B2B sectors with high recurring revenues and avoided more recession-prone consumer businesses, applying highest selectivity: we invested in only 3.5% of the opportunities we analysed.

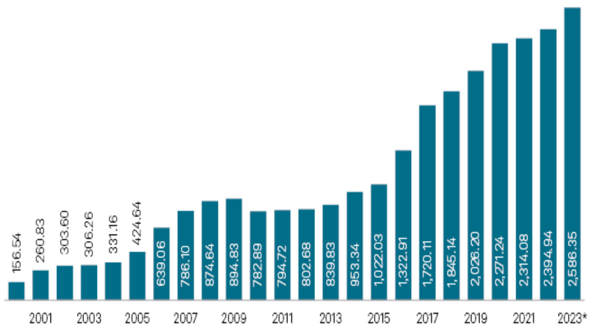
Deep due diligence on every deal

When committing to a fund, investors are not involved in the due diligence on a specific investment. In deal-by-deal situations investors work in parallel with the sponsor and, at the time of taking an investment decision, have quasi the same level of information as the sponsor. In difficult economic environments, this is especially valuable.

Lower and negotiable fees

Fees are especially painful when they are paid on "dry powder", i.e. uninvested commitments, which is the norm in private equity funds. Dry powder currently stands at record levels (*Figure 3*). In the independent sponsor world, management fees are negotiated individually for every transaction and are typically in the range of 1% on invested capital rather than 2% on committed capital.

Figure 3: Global dry powder (uninvested commitments to private equity funds)[3]



Data compiled Dec. 1, 2023.
* Year to date through Dec. 1, 2023.
Analysis includes aggregate dry powder of global private equity funds with vintage year between 2000 and 2023.

A one-off transaction fee might come on top. The performance fee is usually set at 10% (possibly with ratchets for "super-performance") rather than the traditional 20%. Hurdle rates are typically at 8% - 10%. The lower performance fee is to compensate for the fact that independent sponsors have a chance to earn a performance fee on every single deal and don't need to get a full fund with 10 – 15 investments above the hurdle rate.

[3] S&P Global Market Intelligence and Preqin

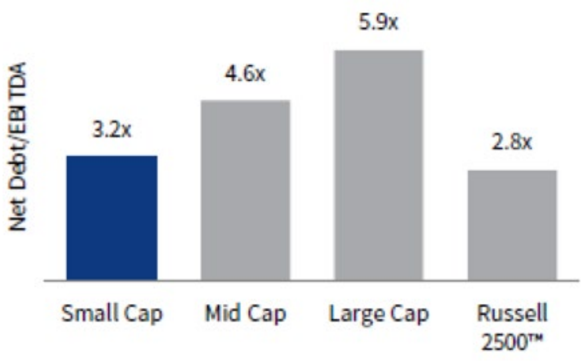
"Off-market" small-cap transactions

Independent sponsors are not set up to bid in competitive auctions, where the availability of funding (i.e. having a fund) is often a pre-requisite. Independent sponsors typically source transactions off-market through their network and seek funding only once an attractive transaction has been identified. As a result, independent sponsor transactions, are mostly true small-cap deals (EV of EUR 20m – 100m) and often negotiated at better prices than auctioned deals.

Lower dependence on leverage

Given the small-cap nature of the investments, debt usually plays no or a minor role in the cap table and in the value creation thesis. For example, *Figure 4* compares leverage across different private equity transaction sizes in the US. Unfortunately, we don't have the same data set readily available for Europe.

Figure 4: Leverage (Net debt / EBITDA) as a function of transaction size[4]



However, across all 15 European investments of Yana, entry leverage was 1.4x net debt / EBITDA. In an environment where leverage has a real cost again, creating value through growth rather than leverage has become especially crucial.

Lower acquisition prices for buy-and-build and M&A strategies

In many small-cap transactions, a "buy-and-build" strategy and local or international acquisitions are a major part of the value-creation plan to generate a 3-4x multiple on invested capital. In the currently "depressed" environment, such acquisitions can be executed at more attractive price levels than a few years ago, creating further upside potential at exit.

More control

Deal-by-deal transactions are usually executed in a small group of 3-5 investors. Depending on the size of an investor's contribution to the transactions, it is often possible to negotiate board seats, access to board documents, other additional information rights or even the right to replace the independent sponsor in case of underperformance. Such proximity to the assets is not possible in traditional private equity funds or passive LP co-investment transactions.

How to succeed with the deal-by-deal model

While the deal-by-deal model is certainly an interesting and potentially a highly rewarding way to build private equity exposure, it is also a demanding investment approach which requires special skills and engagement:

Speed and reliability

It is not easy for independent sponsors to juggle due diligence on a company, negotiations with a

[4] Cambridge Associates LLC Private Investment Database, March 2022, for companies acquired from 2000 – 2020

selling founder and the search for investors, all at the same time. The challenge might be aggravated when bidding for an asset against a traditional private equity fund which can prove the availability of capital easily. It is therefore key for independent sponsors to have established relationships with reliable investors, who work alongside the sponsor at the same speed and with full transparency on their appetite for the investment. An equity support letter from such an experienced investor can sometimes help the sponsor to get into exclusivity. For investors, it is important to understand that "dropping out" in the last minute can destroy a transaction.

Extensive independent sponsor network

The key to a diversified and cherry-picked deal-by-deal portfolio is an extensive network of independent sponsors who regularly provide deal flow. Selectivity on deals and on sponsors alike is crucial for performance. However, the independent sponsor market is an opaque market, and it takes years to build close relationships and trust with the sponsors. At Yana, we have built a network of approximately 150 European independent sponsors providing us with ongoing deal flow. Keeping the independent sponsor network "alive" is an ongoing task: certain sponsors move on to raise a fund, others might fall apart, while new independent sponsors emerge through spin-offs from established private equity firms. "Scouting" for independent sponsors is a time-consuming mission.

Direct investment skills

In the end, deal-by-deal investing is "direct investing" which requires a specific skill set. Investors need to be sparring partners for the sponsor, able to both challenge and advise them. For example, coming out of large established private equity funds, independent sponsors often have little or no experience with single-asset legal structures. Experienced deal-by-deal investors like Yana can add true value in such situations.

High level of involvement

As mentioned before, it is key to run with the sponsor team, not behind them. Closing on a deal-by-deal investment can take 2-6 months, depending on the complexity of the transaction. During this period, investors in independent sponsor transactions will be highly solicited and need to (re)act fast on new information and developments. Once a transaction has closed, board roles, other advisory roles and more informal cooperation with the sponsor and the company continue to require a high level of involvement, not comparable to fund investing.

A well-defined strategy

Many investors, especially family offices, have done direct investment sporadically, often proposed by a close relationship, without putting it into a portfolio context. If a first investment performs badly, the direct investment approach is quickly abandoned. Like any other investment approach, deal-by-deal investing requires a strategy: it needs a defined target exposure in 5-6 years, annual investment volumes and number of transactions, average investment tickets, diversification targets across countries, sectors and independent sponsors, and it needs the corresponding staffing. To achieve a reasonable diversification, we recommend investors to build a portfolio of 15-20 investments over 4-5 years by investing into 3-4 transactions per annum.

At Yana Investment Partners we have been pursuing deal-by-deal transactions alongside independent sponsors for seven years. As of to date, we have invested in 15 transactions alongside 14 independent sponsors across two vintage portfolios (2019 – 2021 and 2022 – 2024). We are excited to invest in what we believe to be the most rewarding segment of private equity (small-cap transactions) alongside highly motivated partners (independent sponsors) with an outstanding alignment of interests.

Please feel free to contact us for any further information.

About Yana Investment Partners

Yana Investment Partners is an independent private equity firm based in Vienna and London, focusing on European small-cap investments in partnership with independent sponsors.

We systematically partner with local deal partners to source and execute high quality transactions. The tight cooperation with deal partners assures significant deal flow across the whole of Europe, on-the-ground local and sector expertise focused on value creation, the ability to select the best opportunities without location bias, and diversification over deal partners, sectors, countries and deal types.

Our investors are institutions, family offices and banks seeking more direct exposure in private equity through cost-efficient and flexible solutions.

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