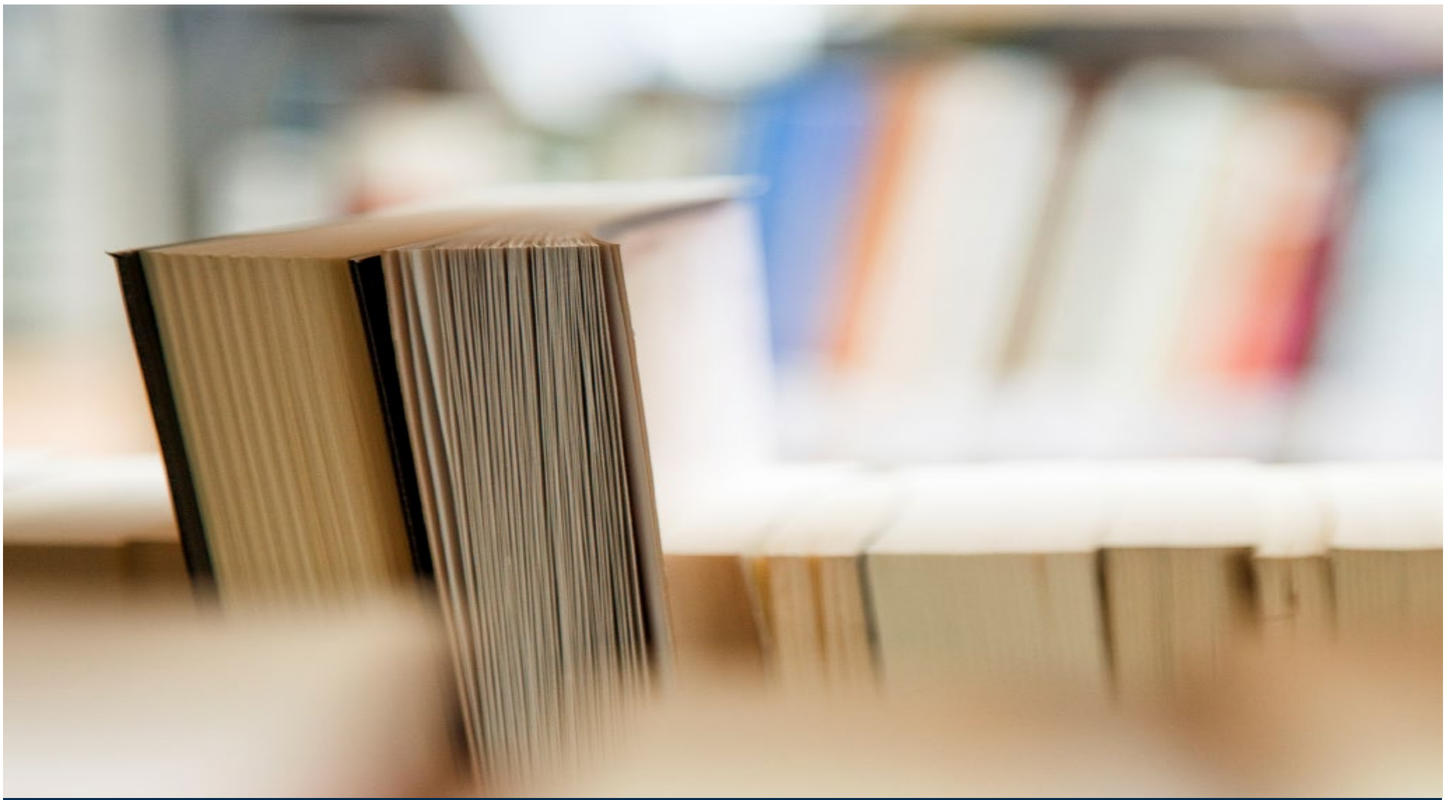


YANA INVESTMENT PARTNERS

Insight

No fund, no problem...

Independent sponsors

Insight into the discreet but growing universe of European independent private equity sponsors

October 2020

Content

No fund, no problem...

Independent sponsors

Insight into the discreet but growing universe of European independent private equity sponsors

Introduction

In Europe, independent sponsors are still a relatively unknown species of private equity market participants. Also called deal-by-deal sponsors or fundless sponsors, their operating model of executing private equity transactions deal-by-deal, without having a fund, is better established in the US.

However, with investors seeking to invest more directly in private companies and the traditional fund model under scrutiny, the independent sponsor model is gaining traction and acceptance amongst European investors who seek a more flexible, targeted, hands-on and cost efficient way to build a private equity portfolio.

At Yana Investment Partners, we partner with independent sponsors to source and execute direct private equity transactions for our investors. In this report we seek to share some of our insight and experience and create more awareness for this exciting and emerging private equity segment.

What are independent sponsors?

Put simply, independent sponsors are private equity managers who acquire companies without having a fund from which to invest. They seek capital from investors for each individual deal, hence the alternative names “fundless” sponsors or “deal-by-deal” sponsors. As a US independent sponsor put it: “We used to call ourselves fundless sponsors, but that sounded too much like being a homeless person."[1]

“We used to call ourselves fundless sponsors, but that sounded too much like being a homeless person...”

Richard Baum - Consumer Growth Partners

[1] Richard Baum, Consumer Growth Partners, in an interview with Aaron Elstein, “Nimble investors are making big deals by outhustling private equity giants”. Crain’s New York Business, April 23rd, 2019

Discreet but a growing number

Because independent sponsors typically operate "under the radar", not always announce their deals in the press and cannot be found in fund raising league tables, it is difficult to know exactly how many there are out there. Anecdotal evidence and research by Citrin Cooperman[2] indicate that in the US alone there are probably 400-500 independent sponsor groups, responsible for approx. 25% of private equity deals executed in the US.

In Europe, where the market is still less developed, we have evidence that there are over 150 independent sponsor groups. With over 40 independent sponsors, the model has gained a strong foothold in the United Kingdom but has also spread to the continent, with the DACH region showing the highest concentration.

Small but experienced teams

Independent sponsor teams typically operate with two to three partners, rarely more. Depending on how long they are established, they might be supported by a few associates and analysts. Especially sector focused sponsors might complement their teams with senior industry advisors for deal sourcing and post-investment value creation.

Partners at independent sponsor firms have diverse backgrounds. Many are former partners or directors of established private equity firms, corporate finance advisors, C-level executives or previous entrepreneurs. What they have in common is an extensive expertise in buying, owning, managing or advising private companies, often combined with specific sector expertise. The independent sponsor market is not an advisable route for less experienced people to enter the private equity world.

High level of attention to fewer deals

Most independent sponsors very selectively execute roughly one deal per year, i.e. less than a traditional private equity firm in the same period. Even established independent sponsors with several years of operational history therefore rarely hold more than 5-6 portfolio companies at any given time. This allows them to provide a high level of attention to each of their portfolio companies, despite having small teams.

Like small-cap private equity funds, independent sponsors typically have either a narrow geographical focus (single countries, or regions like DACH, Scandinavia) or a sector focus (e.g. consumer, software, industrial, etc.). Sometimes, geographical and sector focus are combined.

Focus on small-cap, avoiding competitive processes

Most independent sponsors source deals from their own network, through personal industry contacts, boutique M&A advisors and accountants. Given the absence of a pre-committed fund (i.e. readily available capital), they do not like fast auction processes and seek to identify truly "proprietary" transactions where they can build a relationship with the seller and the management team ahead of time, get to know the company and develop a value-creation plan.

Because most larger deals are auctioned, the lower end of the market is their natural hunting ground. Transaction sizes range mostly from EUR 15m to EUR 70m (median of EUR 31.5m for YANA reviewed transactions) with equity requirements of between EUR 10m and EUR 50m.

[2] Citrin Cooperman, Independent Sponsor Report, 2019

> *“You need an angle or specialisation to win deals in this space. In our last deal we ended up brainstorming with management how to improve the business. It became an impromptu strategy session…”*
>
> Pieter Hooft – Cadence Equity Partners

Independent sponsors usually invest in buyout, buy-and-build, replacement and growth capital situations. Due to intense pre-acquisition interaction between the company and the sponsor, the post-acquisition value creation strategy is typically well defined in advance and often includes internationalisation of the company, add-on acquisitions to achieve critical mass, top-line growth or the move to more technology driven business models. We have not encountered a significant number of independent sponsors in the venture capital space.

To summarise, in many respects an independent sponsor has characteristics similar to a small-cap private equity manager without the constraints - but also without the benefits - of managing a closed end fund.

Failed GPs or a truly differentiated model?

In Europe, the independent sponsor market still has a bit of a reputation issue. Some investors consider independent sponsors as "failed GPs" that do not succeed to raise a fund. While this might be true in certain cases and deep due diligence on the sponsor, its track record, motivation and perennity is key when investing alongside an independent sponsor, there is a growing number of high-quality players in the market who are genuinely convinced of the model, be it as a long term strategy or as a temporary strategy to increase the success probability of a future fundraise.

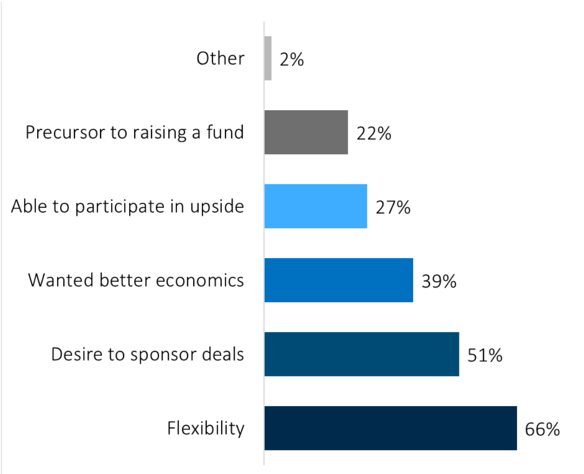
In a 2019 survey of US independent sponsors, Citrin Cooperman found that a majority chose to become independent sponsors due to the flexibility of the investment model (66%) and based on the desire to sponsor own deals (51%)[3]

YANA has been focusing on the emerging and independent sponsor segment since inception. We have over 120 independent sponsors in our database and are in regular dialogue with around 75 of them across Europe. Based on our European experience we believe there are three key drivers for the emergence of the independent sponsor model over the last 10 – 15 years:

1) Disappointment with the large-cap space
2) Building a track-record prior to raising a fund
3) Lasting conviction about the strength of the business model

We discuss these reasons in more detail below.

Reasons to become independent sponsors[4]



Disappointment with the large-cap space

The private equity market and fund sizes have grown to such an extent over the last 20 years that many senior private equity professionals, often at director or even partner level, find themselves alienated from their previously desirable jobs. They are involved in highly contested auction processes, competing against most other European large-cap firms, knowing that only the highest bidder will win. They neither have time nor access to sellers and management to build a strong view on value creation potential. In the rare case of winning an auction, external consultants or in-house operational teams are appointed to propose and implement value-creation initiatives, pushing the private equity manager into a coordination role.

[3] Citrin Cooperman, Independent Sponsor Report 2019 (multiple answers possible)

[4] Citrin Cooperman, Independent Sponsor Report 2019 (multiple answers possible)

Being personally involved in the whole private equity value chain seems to be a key motivation for most independent sponsors.

Becoming an independent sponsor is therefore often a move "back to the roots" of private equity: Identifying small, "off-market" transactions, getting to know the owners and the managers, structuring a suitable deal and supporting long-term value creation. Being personally involved in the whole value chain seems to be a key motivation for most independent sponsors.

Building a track-record before raising a fund

Even the most experienced private equity professionals face tremendous scrutiny from institutional investors when they seek to raise a first fund. Since a few years, institutional investors have been streamlining their portfolios through a focus on fewer but larger commitments to established relationships, leaving little room for first time funds. In the first half of 2020, the total number of fund vehicles raised was down 25% versus 2019, continuing a trend started in 2018. Nevertheless, assets raised increased as 74% of capital committed went into multi-billion funds[5].

Many placement agents nowadays recommend emerging sponsors to "get a few deals done and prove that you can do it" before rushing into a fundraise. Once a deal-by-deal track record of four to five deals and a network of supportive investors has been built, fundraising should become easier.

According to the 2019 study by Citrin Cooperman, 31% of young independent sponsor (defined as less than 6 years old) do not want to raise a fund in the future, while the remaining 69% either don't know yet (45%) or eventually want to raise a fund (23%). This contrasts with established independent sponsor where a large majority (73%) do not want to raise a fund in the future.[6] The first years as independent sponsor seem to be a test-period, and many firms end up liking the model to the point they want to stick with it. We will look at some of these advantages in the next section.

"We initially wanted to have a blind-pool fund first. This plan was taken over by an exciting transaction opportunity which we executed through a "single platform fund". At the same time, we are continuing to raise our "traditional" fund. I think as a new team it needs agility to be successful."

Dominic Faber - KKA

Based on our experience, we believe that raising a fund is still the ultimate goal of most European independent sponsors. There are two explanations for this: first, the independent sponsor market in Europe is younger and less developed than in the US. There are less "established" emerging sponsors and more "young" independent sponsors which are still testing the model. Second, investing on a deal-by-deal basis is still less common amongst European investors than in the US. Raising capital for each individual deal is therefore a tiring and time-consuming task, leading to missed transaction opportunities. This might ultimately push independent sponsors to raising a fund.

[5] Pitchbook, Q2 Private Fund Strategies Report 2020

[6] Citrin Cooperman, Independent Sponsor Report 2019

Strengths of the business model: the sponsor view

Flexibility

Investment restrictions and the closed end nature of traditional funds can put important constraints on deal doing: Typically, capital must be deployed over 3-4 years in 8-15 companies. Holding periods for individual companies of more than 4-5 years raise questions from investors. Minimum and maximum equity tickets per company must be within well-defined limits to achieve balanced diversification.

"The attraction is that we have greater flexibility when it comes to deal sizes and deal structuring. With a fund, I think we would be more constrained. We seek to structure each transaction to its needs."

Pieter Hooft – Cadence Equity Partners

Independent sponsors do not need to live with such constraints. They can abstain from doing deals when no attractive opportunities arise. They can consider small as well as larger deals if they believe to have an edge. Important to many entrepreneurs, their holding period can be longer than in traditional funds, as long as investors are aligned. "Patient capital" and "long term partners" are expressions often found on independent sponsors' webpages.

More pre-acquisition insight

The focus on "off-market" and less competitive processes allows independent sponsors to get more insight into an acquisition target than would be possible in a highly intermediated, fast moving auction process.

"The difficulty is timing. We need time to close a transaction. The good thing is that we get to spend more time with management and the company."

Nicola Zambon – Cleon Capital

Whenever possible, independent sponsors seek to build relationships with previous owners and management over several months before getting into exclusivity. There are cases where deals were "crafted" by independent sponsors where there was none, by persuading business owners of a transaction. This can be a challenging task as entrepreneurs are often uncertain about the best timing to sell their company. As a result, the insight into the company is better at closing, and value-creation initiatives have typically already been outlined.

Deal-by-deal carried interest

While most funds in Europe pay carried interest only towards the end of their life, once all the capital and the preferred return has been paid to investors, independent sponsors usually get deal-by-deal carried interest. This is attractive for the partners but also useful to incentivise younger team members. Given the lower management fees in the independent sponsor model, carried interest can be crucial for the survival of the sponsor.

Strengths of the business model: the investor view

Depending on transaction size and personal wealth of the independent sponsors, they typically invest between 2% - 5% of the required equity. In smaller transactions this number can go up to 10% or more. As one sponsor put it: "I have to do personal cash-planning for the next 5–6 transactions, as our investors want us to be aligned in each of our deals".

The remaining capital currently comes from three different types of sources:

- Ultra-high net worth individuals, small single-family offices and entrepreneurs: Smaller and younger independent sponsors typically start off with a pool of friends & family capital. However, this funding source is often limited in size and might be "exhausted" after a few transactions. Such sponsors rather focus on minority and growth capital transactions, where a smaller pool of capital is less of an issue.
- Sponsors with "institutional" ambitions are interested in shaping relationships with investors that can contribute a larger pool of capital over a longer period, and possibly commit to a future fund. These investors are usually larger family offices, secondary managers, co-investment managers and funds of funds in search of more "bang for the buck" and lower costs.
- To a lesser extent and mainly in the US, traditional institutions like pension funds, insurance companies and foundations with significant allocations to private equity, have discovered the virtues of deal-by-deal investing to fine-tune their portfolio allocation and to reduce costs. They appreciate working alongside independent sponsors for sourcing and ongoing value-creation.

> *"A substantial amount of our capital comes from entrepreneurs who, in addition to flexible funding, bring unparallel business experience. This approach appeals to management of our target companies who often become investors in our future deals."*
>
> Nicola Zambon – Cleon Capital

The key advantages of the independent sponsor model for investors are the following:

Off-market transactions

Most independent sponsor deals are "off-market", small-cap transactions, sourced by the sponsor through its own personal network and specialist niche brokers. Facing less competition than larger deals, acquisition multiples are typically substantially lower (4-6x EBITDA) than at the large end of the market and are often priced to generate a target return of 3-4x invested capital. With little or no leverage, risks and returns are rather operational than financial.

Free deal flow and lower total costs

The deal-by-deal model gives investors free optionality on deal flow. Costs only occur if the investor decides to invest, and even then, they are lower than in a traditional fund (see Section "Remuneration", page 16). This reduces the overall costs of private equity investing and substantially mitigates the J-curve.

Control over portfolio without blind-pool risk

The ability to pick and choose removes the blind-pool risk of traditional private equity funds. This is attractive for investors who have strong opinions and preferences regarding sectors, geographies and deal situations (e.g. management buy-out versus buy-in, owner rollover, organic growth versus add-on acquisitions etc.).

Alignment

Several factors strongly align investors and sponsors in the deal-by-deal model.

- **Only performance matters:** Because management fees are lower and paid only on invested capital, they are typically just about sufficient to keep the team going, but not to get wealthy. This is especially true for young sponsor firms with only one or two deals in their portfolio. Performance is therefore key to create personal wealth.
- **More capital at higher risk:** As a sign of conviction, independent sponsors invest substantial own capital in every deal. Owning a more concentrated portfolio than fund managers, they take a higher risk and the penalty for underperformance is substantial.
- **Every deal counts:** Given that investors can decide on every new deal, underperformance in previous deals will quickly be punished by stopping the cooperation. There is very little room for error, especially in the first deals.

Hands-on and focused

Independent sponsors execute one to two transactions a year, most typically one. Even for an established independent sponsor firm it is unlikely that it will ever hold more than 5-6 companies in its portfolio simultaneously. Each new transaction, but also each existing portfolio company therefore gets a high level of attention and hands-on operational support.

No pain, no gain: the challenges of the independent sponsor model

The private equity fund investment model was not invented without a reason. Thus, it is no surprise that some of the advantages of the fund model are the challenges of the independent sponsor model.

Volatile revenues and deal-flow

Traditional private equity managers receive fees based on committed capital. This gives them planning certainty and income for the next five years to build their teams. Because independent sponsors only get paid on closed transactions, they lack this planning certainty and might find it more difficult to build a team with second-level people that need regular income.

Cyclical investor behaviour

Closed end funds with "pre-committed" capital can exploit attractive acquisition opportunities in a downturn without having to approach investors. As investor wallets are often closed during a downturn, independent sponsors struggle more to exploit these opportunities. Building a diversified, loyal, and sophisticated group of supportive investors that are willing and capable to exploit opportunities in a downturn, should therefore be a key strategic goal already in good times.

Surviving broken deal costs

Traditional private equity managers charge broken deal costs (due diligence costs on aborted deals) to their fund and thus indirectly to their investors. Independent sponsors need to do substantial due diligence and incur external costs before investors commit to a transaction and accept to share these costs. Having to pay abort costs out of their own pocket is therefore a big risk, especially for younger emerging sponsors with little cash on the side. Many due diligence service providers might be willing to discount their bills in the case of an aborted deal, but rarely do they wave the fees completely. Other service providers might roll fees into the next transaction, thus creating other conflicts.

Closing a transaction against the odds

While some independent sponsor deals are genuinely exclusive, many face (limited) competition. When competing against two to three other capital providers, the lack of readily available capital can be a challenge. Just to be "in the race", the sponsor firm needs to convince the sell-side advisor that funding will not be an issue. Once in the next round, the sponsor needs to invest time and money on several fronts: understanding and analysing the business, kick-starting external due diligence (commercial, tax, legal, etc.) and simultaneously building up an interested investor group.

> *"In order to be an independent sponsor today, you need a network on the deal side and a strategy for sourcing deals which allow you to compete in a niche. You also need governance structure and experience to ensure that your potential investors are comfortable that you have things under control."*
>
> Guy Semmens – Gyrus Capital

Investors, on the other hand, need to assess the merits of the transaction, form an educated view on the sponsor and negotiate transaction terms and governance with the sponsor, all usually within a few weeks and with imperfect and evolving information. The successful completion of a transaction is thus far from certain and depends on multiple professional parties working hand in hand. Living up to the high level of information requirements from investors is not always an easy task for sponsors who come out of large organisations where investor communication is usually taken care of by the investor relations team.

"While independent sponsors know very well how to do deals, they often need to learn how to cooperate with investors along the deal process. They just didn't need to do this in their previous organisations with fully staffed investor relations departments…"

Stephan Seissl – Yana Investment Partners

Sponsors need a lot of entrepreneurial drive and project management skills to make these transactions possible "against the odds". A pre-existing relationship between sponsor and investor facilitates the process as it allows for the focus to be fully on the deal.

Resource intense diversification

For investors, building a direct portfolio of independent sponsor deals is resource intense. A prudent approach is probably to build a portfolio of approximately 15 transactions over 3-4 years and to diversify across different sponsors, countries, sectors and deal types. This requires a large network of independent sponsors, understanding their strengths and weaknesses, maintaining an ongoing relationship and being a fair sparring-partner.

"In the small-cap space, company and sponsor risks are probably much more relevant than sector or country risks. It's a bottom-up play. Any deal or sponsor can fall apart. A minimum of diversification and intimate knowledge of your sponsors and transactions are key."

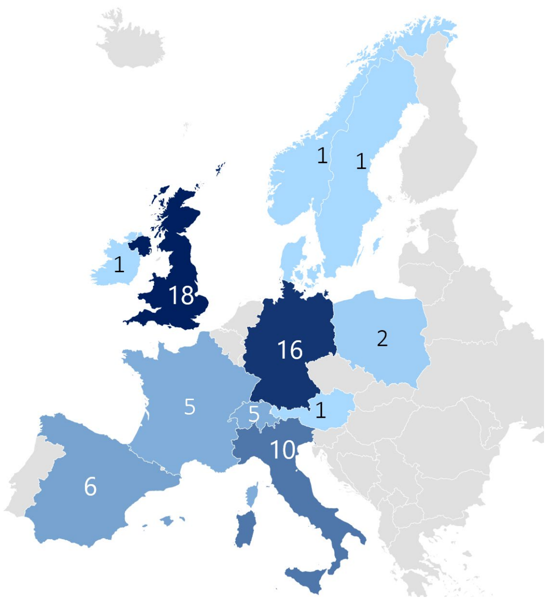
Hanspeter Bader – Yana Investment Partners

Unlike traditional co-investments with established GPs, partnering on an independent sponsor deal typically means two to four months of work, early involvement, deep dive due diligence, building an independent view, negotiating terms and governance and post-closing monitoring through (observer-) board seats or more informally. Executing 4-5 independent sponsor transactions per annum absorbs resources and has an internal (or outsourced) cost that needs to be considered.

Anatomy of European independent sponsor transactions

At Yana Investment Partners, we partner with independent sponsors to source and execute European direct private equity transactions. We have reviewed well above 120 transactions from 65 sponsors and have detailed transaction data on 68 transactions. These transactions cover the period from January 2019 to July 2020. We do not claim exhaustiveness and transaction type and location possibly have a selection or "network" bias (for example, we are not actively looking for venture capital transactions). Nevertheless, we believe that the 68 transactions give a good insight into the typical "anatomy" of a European independent sponsor deal.

Deals by country

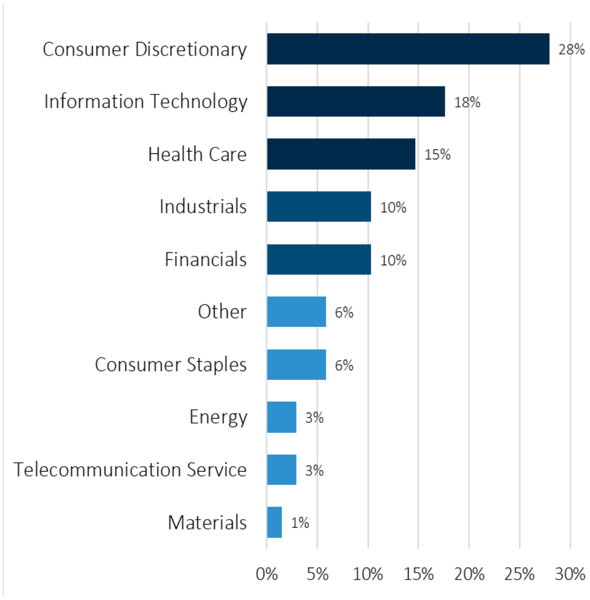


Geographical and sector activity

We saw by far most deal activity in the UK and Germany, followed by Italy and Spain. This, of course, correlates with the strong presence of local independent sponsors and a tight tissue of SMEs in the UK and in Germany. The dominance of Italy and Spain over France and other European countries might level out over time as our database continues to grow. However, as a French market participant put it, "the French private equity landscape is very competitive with a limited amount of transactions and dominated by large institutional investors. This leaves little room for smaller independent sponsors."

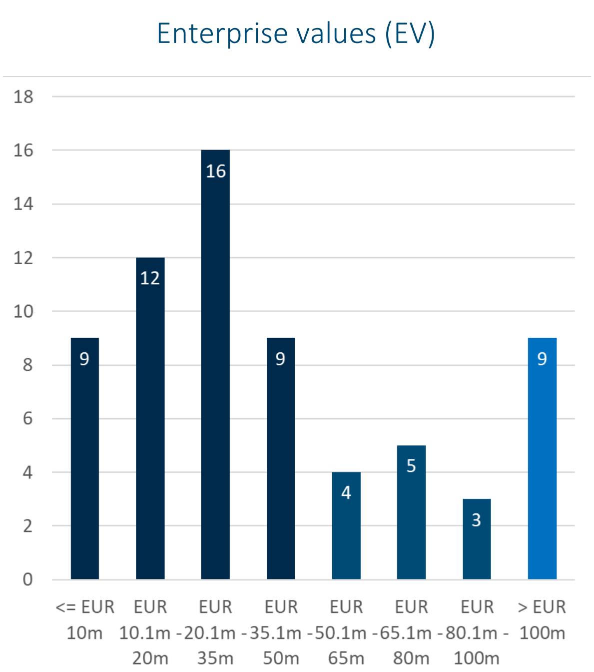
The consumer sector, information technology, healthcare and business services were the most active segments over the observation period, profiting from general tailwind for these industries.

Deals by sector



Company size

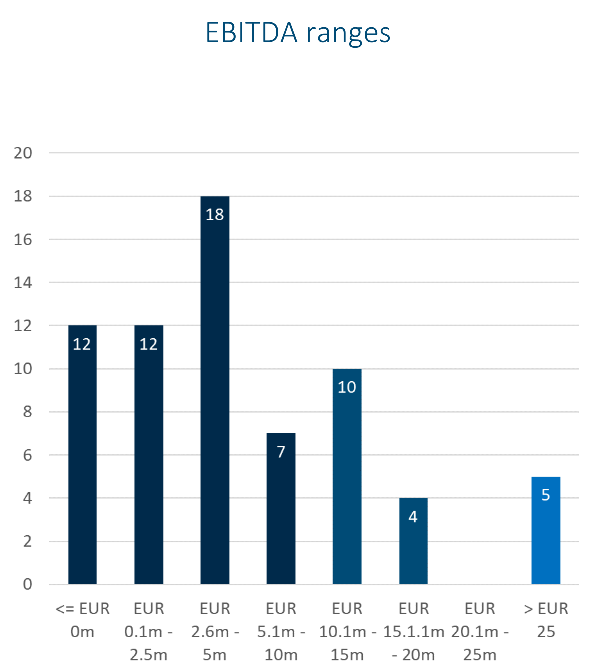
In line with our previous reasoning, the majority of independent sponsor transactions happen at the lower end of the size spectrum. YANA has seen transactions with enterprise values (EV) ranging from EUR 3m to EUR 140m, with a median of EUR 31.5m, lower quartile of EUR 16m and top quartile of 71m.

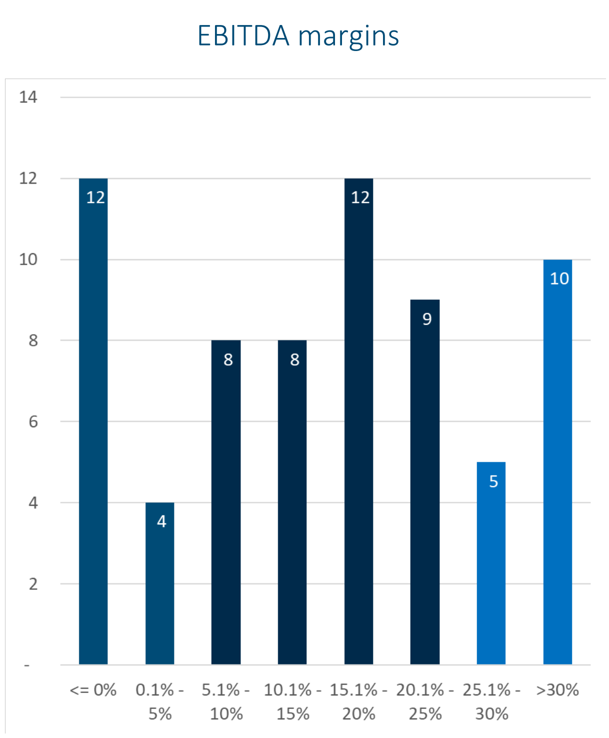


Profitability

The average EBITDA of companies in the sample was EUR 7.2m, with a median of EUR 3.5m, an upper quartile of EUR 7.2m and a lower quartile of EUR 1.0m.

Despite a certain focus on younger and growing companies, EBITDA margins of our observed transactions were very healthy, with the median at 18%, the lower quartile at 8% and the upper quartile at 25%. Independent sponsors seem to have a strong focus on the ability of an acquisition target to generate cash.





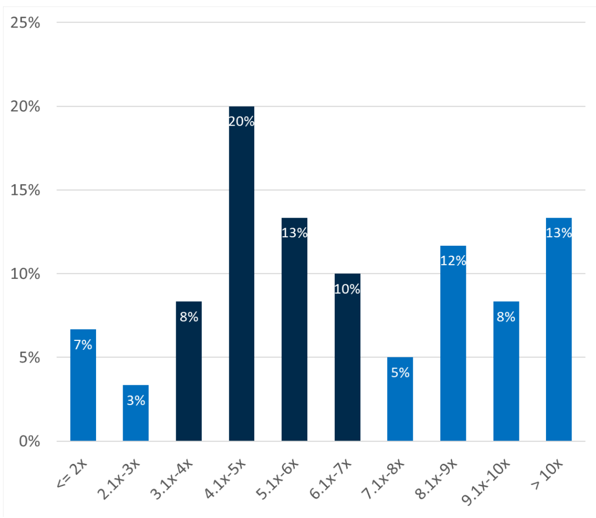
Valuations

Several studies have shown that small-cap transactions are generally less costly than large-cap transactions. While large-cap valuations hovered around multiples of 10-12x EV/EBITDA in recent years[7], valuations of small-cap companies are rather in the range of 6-8x EV/EBITDA[8]. This has several reasons, including higher risk and volatility of earnings, less competition for smaller deals and less debt availability, which requires lower acquisition prices to achieve the target returns.

To analyse our independent sponsor sample, we excluded early stage growth capital transactions to look at valuations, ending up with a sample of 61 buyouts.

These buyouts showed a median valuation multiple of 5.8x EV/EBITDA, a lower quartile of 4,4x EV/EBITDA and an upper quartile of 9x EV/EBITDA, with just above 50% of valuations being in the range of 3x - 7x EV/EBITDA.

Buyouts only: EV / EBITDA

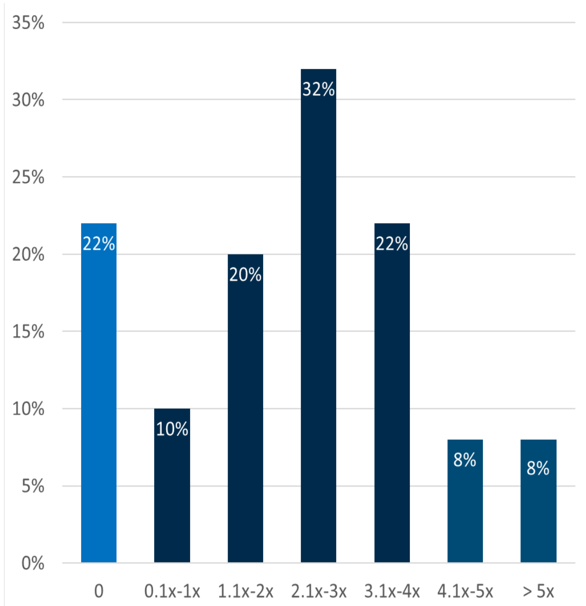


The highest valuations (9x EBITDA or more) could all be attributed to consumer businesses (mostly branded), financial services and IT.

The use of debt

Excluding growth capital transactions from the debt analysis, we have a data sample of 61 buyout transactions. Leverage levels were generally modest, with a median of 2.6x Debt/EBITDA, an upper quartile of 3.5x Debt/EBITDA and a lower quartile of 1.0x Debt/EBITDA. Over 20% of transactions did not use debt at all. These figures compare to Debt/EBITDA levels of 6x and more for traditional larger buyout transactions[9].

Buyouts only: Debt / EBITDA



There are various explanations for the lower use of debt:

- given the small-cap nature of independent sponsor transactions, banks are less (or not)

[7] For example Bain & Company, "Global Private Equity Report 2019", December 11th 2019
8 For example Kempen, "Small is beautiful", May 2019

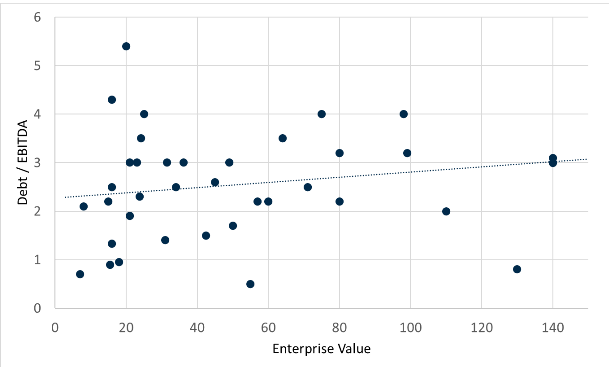
9 Bain & Company, "Global private Equity Report 2019", December 11th 2019.

willing to lend high amounts at reasonable rates.

- When add-ons are an integral part of the value creation strategy, independent sponsors often seek to acquire the original platform without debt to leave room to finance the add-on acquisitions with bank debt.
- Independent sponsors seek to reduce the equity requirement with other means. Vendor loans and substantial re-investment of the selling owner – so called "roll-overs" – of 20-30% are quite common.

Within our sample and for those deals that actually used debt, we have not found a strong correlation between debt level and enterprise value, as the wide scattering of the data points around the trendline shows in below graph.

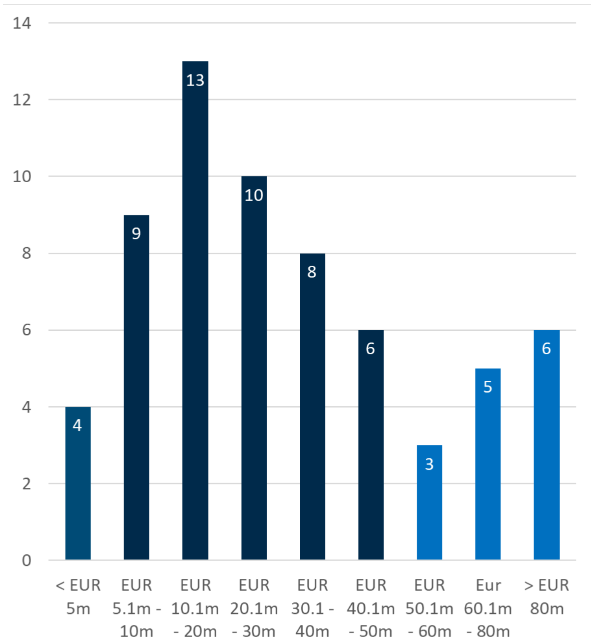
The use of debt as a function of EV



Required equity

The median equity requirement for our reviewed transactions was EUR 26.5m, with the lower quartile at EUR 13.4m and the upper quartile at EUR 48m.

Total equity requirement



Remuneration

Fees in the European independent sponsor market still vary strongly and it is difficult to discuss them with statistical relevance for the following reasons:

- Due to the immature nature of the European independent sponsor market, market participants are still in the “finding phase”. No clear standards are set yet.
- Fees asked for by the independent sponsors at the beginning of a deal process are typically substantially higher than the fees that investors and sponsors finally agree on. We therefore do not necessarily know the fees of all transactions which we reviewed but then declined.
- The investor type has a large impact on fees. Some independent sponsors fund their deals with a large number of ultra-high net worth investors (UHNIs) and small family offices in individual ticket sizes of EUR 0.5 – 1.0 million. In this case, fees are higher. Others fund their transactions with two to four large tickets from institutional investors (large family offices, private equity asset managers, pensions, etc.). Fees in this case are substantially lower.
- Many independent sponsors “do this for a living”, i.e. they manage transactions for third party investors. Thus, they seek a fee that allows them to build and grow their business. Other independent sponsors mainly seek to get their own wealth at work, investing 15% - 20% or more in a deal. These sponsors are less fee sensitive, as outside investors are brought in mainly to get the deal done.

In general, there are three types of compensation for independent sponsors: management fees, transaction fees and performance fees.

Management fees

When working with a small group of institutional investors, mutually agreed management fees typically end up in the range of 0.8% - 1.2% p.a. of total required equity.

When sourcing capital from UHNI’s and small family offices, the typical fee range is in the range of 1.5% - 2.0% p.a. of total required equity.

An interesting difference to the US market is that fees in Europe are typically expressed as a percentage of required equity. In the US, fees are more commonly expressed as a percentage of EBITDA (most often 5% p.a., but ranging from 2% to 6% p.a.), combined with a floor and a cap or only with a floor[10]. We believe that this expresses the fact that European independent sponsors still have the fund model in mind when setting fees, where the total capital committed to a fund represents the total equity that can be invested in portfolio companies.

EBITDA-based fees are an interesting alternative, as it makes fees independent of the debt/equity mix. If not EBITDA based, management fees in the US are also charged on a flat rate basis. Below table shows that, depending on the level of debt, the US EBITDA-based fee model generates approximately the same level of fees as the institutional fees achievable for European independent sponsors.

[10] Citrin Cooperman, Independent Sponsor Report 2019

Equity versus EBITDA based fees

US % of EBITDA	< corresponding to >	Europe % of Equity
4%	Debt of 0%	0.67%
4%	Debt of 20%	0.83%
4%	Debt of 30%	0.95%
5%	Debt of 0%	0.83%
5%	Debt of 20%	1.04%
5%	Debt of 30%	1.19%
6%	Debt of 0%	1.00%
6%	Debt of 20%	1.25%
6%	Debt of 30%	1.43%

Performance fees and hurdle rates

By far the most common performance fee range is between 10% and 12.5%. In rare cases the sponsor can achieve 15% performance fees if the transaction shows extraordinary upside potential or requires above average ongoing involvement from the sponsor.

The hurdle rate is typically set at 8% or 10% IRR p.a. The 8% IRR p.a. is more common in buyout and buy-and-build situations, whereas 10% IRR p.a. is more common in growth capital transactions.

64% of transactions had only one hurdle rate. The remaining 36% had ratcheted hurdles, i.e. increasing performance fees with increasing returns, for example 15% performance fee for a return above 2.5x invested capital and a 20% performance fee for a return above 3.5x invested capital.

The first hurdle rate is typically expressed as an IRR. Further ratchets are often depending on exceeding a combination of IRR and investment multiple (e.g. 2.5x multiple and 25% IRR).

The lower level of carried interest than in traditional private equity funds (typically 20% above 8% IRR p.a. in funds) can be explained by the deal-by-deal nature of the carried interest. Independent sponsors have a chance to make a carried interest on every single deal, without having to give back money on underperforming deals. In a traditional fund, a private equity manager has to get the sum of all the deals right in order to trigger carried interest payments.

Transaction fees

One-off transaction or closing fees can be considered a compensation for the upfront due diligence work and / or for not using a buy-side M&A advisor but rather doing the work inhouse. Traditional private equity managers charge buy-side advisory services to the fund and finance internal due diligence work through the commitment-based management fees.

Transaction fees can also be considered a “compensation” for sourcing and reviewing many deals that, for multiple reasons, never reach a closing, or for abort-costs that the independent sponsor potentially had to finance out of his own pocket.

Of the YANA reviewed transactions, 60% had a transaction fee while the other 40% did not. The sponsors who did not charge a transactions fee were either pursuing deals at the higher end of the small-cap space or charged comparatively high carried interest.

Among those sponsors who did charge a transaction fee, the typical fee in an institutional setting was 1.0% - 1.5% of equity at closing.

In the US, transaction fees are very often totally or partially re-invested as equity into the transaction. This is still less common in Europe. We explain this with the young nature of most European independent sponsors which need the transaction fee in cash to finance their operations.

Coping with Covid-19

Like storms are a challenge for young trees, Covid-19 is a challenge for independent sponsors. However, we believe that their nimbleness and flexibility also create attractive opportunities.

Challenges

No deals, no income

Deal doing all but came to a halt during the Covid-19 lockdown. Seller and buyer expectations diverge strongly and from past downturns (e.g. GFC) we know that it takes 6-12 months for price expectations to adjust. While traditional private equity fund managers can live from the management fees on committed capital, independent sponsors find it hard to create new revenue streams. This mainly hits the younger independent sponsors, with no or only a couple of deals in their portfolio. Survival strategies might sometimes need to be put in place, like drawing from personal savings or temporarily expanding business activity into M&A or advisory work, without losing focus on the original goal.

Capital providers are in “risk off” mode

Investor have become more prudent. Some stopped investing in private equity or at least reduced allocations. Others focus on re-ups with existing portfolio managers and established large private equity firms. Even if a deal is at hand, financing it has become much more challenging. This might be especially true for those sponsors which rely heavily on UHNIs and small family offices for their funding and less on institutional, more stable investors. Building close relationships with a diversified pool of potential investors should be high on the agenda of every independent sponsor.

Banks focus on government supported “emergency lending”

Banks are also less willing to lend, partially because they are also in “risk off” mode and partially because their resources are absorbed by government supported emergency lending plans. Debt funds with pre-committed capital at hand have become a welcome, although typically more expensive, alternative.

The one and only portfolio company might be hard hit

Best due diligence and macro-analysis could probably not foresee the current pandemic. Owning hard-hit companies absorbs management time, requires fast and radical action and ongoing communication with the portfolio company and investors. Not much time is left for new deal sourcing and closing. Further, an underperforming first or second deal might be an obstacle to raising further capital, because investors want to see measurable performance (preferably realisations, but at least positive company developments) before making a new investment. This will be hard to show over the next months.

Opportunities

Acquisition prices might adjust

Once the new reality has settled in, acquisition multiples might further come down. Market participants we have talked to expect a reduction by 1-2 EBITDA multiples. However, this might not be true for all sectors: internet, software, pharma, health related companies and generally businesses which provide solutions in the context of reduced social interaction, showed little or no price weakness over the last few months. Understanding which business models have a future in this “new normal” is key.

Building a broader, more diversified investors base

Different investor groups behave differently in different market environments. While UHNIs might be more cyclical, some institutions are more counter-cyclical. Private equity asset managers like co-investments funds, secondary funds and funds of funds sit on large amounts of uninvested capital, raised just before a crisis. The lower fees that independent sponsors should expect from more institutional investors might be offset by the advantage of their more stable investment pattern.

Showing hands-on value creation

"When the going gets tough", independent sponsors can best show their hands-on involvement and value-added for portfolio companies. Investors will judge the quality of an independent sponsor by its contribution to the company's survival, constructive strategic measures, speed of implementation and good governance. An absolute "must" during this period is also full transparency and outstanding communication with investors.

> *"We took a step back for three or four months in order to assess the situation. We communicated a lot with investors and increased the frequency of our reporting. Investors felt involved in the process and part of the decisions."*
>
> Nicola Zambon – Cleon Capital

Add-on acquisitions

Many companies are at the brink of bankruptcy and likely open for take-over discussions. 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.

No portfolio, no problems

Young independent sponsors with no or only one or two portfolio companies are less absorbed by trouble shooting than an established fund manager with three funds and possibly 20-25 portfolio companies to look after. This leaves more time for sourcing and executing new transactions or value creation in the few portfolio deals.

More frustration might create good hunting ground

We expect that the frustration level within large-cap private equity firms will rather grow than decrease over the coming years. Passionate deal doers have become trouble shooters and downsizers against their will. We believe that the original reason why many seasoned private equity professionals have become independent sponsors will become even more valid: "back to the essence of private equity".

While we do not downplay the challenges that independent sponsors face due to Covid-19, we believe the focus should be on protecting the existing portfolio, surviving as a sponsor and exploiting opportunities.

About Yana Investment Partners

Co-Investments Partners is an independent private equity firm based in London and Geneva, focusing on direct buyout and growth-capital investments in European small-cap companies.

We systematically partner with local deal partners - typically independent private equity sponsors - 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 across Europe 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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