

Independent Sponsors: The sweet spot for accessing PE talent

KEY TAKEAWAYS:

Independent sponsors are often at the optimal point in their investment careers—experienced enough to identify compelling investments and highly motivated to prove themselves.

Carefully selected independent sponsors can offer an attractive and differentiated source of returns that are additive to a mature buyout portfolio.

The independent sponsor market is vast and requires dedicated resources to source and identify high-potential opportunities.

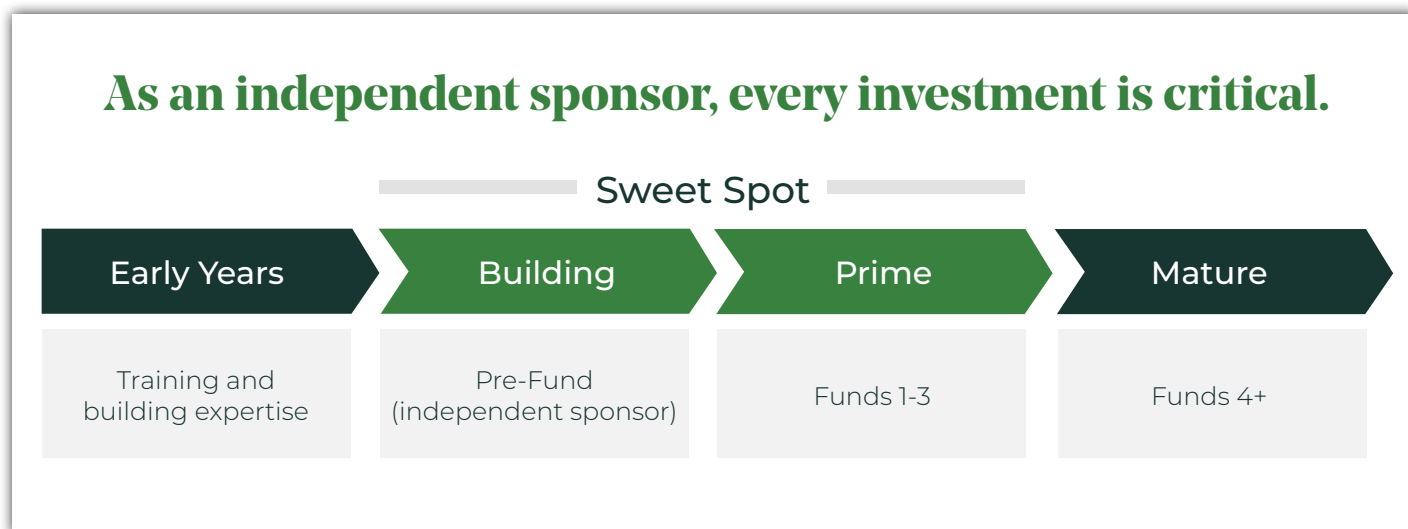
The Case for Independent Sponsors

Amidst the search for attractive investment opportunities, we at GEM have consistently pursued the small buyout market, where a wider dispersion of returns offers a premium for skilled investment selection.¹ While reviewing the marketing materials for thousands of small buyout funds, we have observed that sponsors' pre-fund investments often have the strongest returns relative to their overall track records. This observation led us to initiate a research project on the independent sponsor market nearly a decade ago.

We define an independent sponsor as a private equity investor who is raising capital for investment opportunities on a deal-by-deal basis, typically before raising a committed fund. These sponsors come from all areas of the market: spinouts from private equity firms, former investment bankers, or operators-turned-investors. It is highly competitive to raise a first-time fund, and we have observed that one of the best ways to stand out is to have a fully attributable track record for potential limited partners (LPs) to review. However, most independent sponsors do not receive formal performance attribution from their prior firm and therefore need to build an independent track record. We believe this is a particularly compelling time in the lifecycle of an investor; when raising a committed fund is predicated on a demonstrated ability to outperform, every investment counts.

We believe the most talented independent sponsors are in the “sweet spot” of their careers. They have typically trained at an elite firm and have developed the networks necessary to identify, finance, and operate a portfolio company. At the same time, they remain highly motivated to generate strong returns and grow their firm. **Exhibit 1** illustrates our view of the lifecycle of a private equity investor.

Exhibit 1



Note: For illustrative purposes only.

Role in a Buyout Portfolio

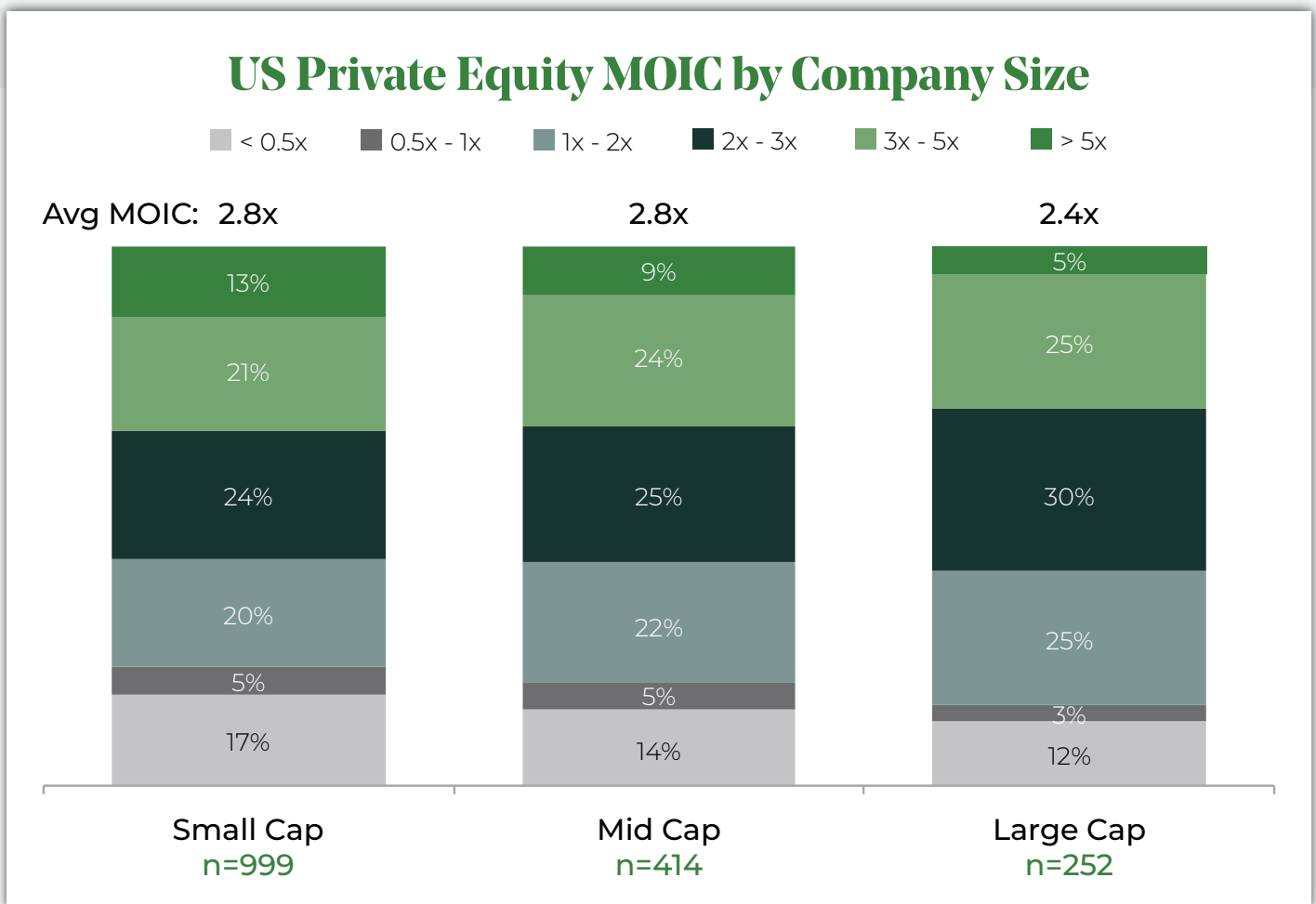
We've written in the past about the potential return-enhancing and diversifying benefits of small buyouts in a portfolio. We view the independent sponsor market as a way to access small buyout exposure in a highly-aligned format, as well as an opportunity to develop core small buyout relationships earlier in the sponsor's lifecycle. As noted in our [small buyout paper](#), we believe the lower middle market is attractive because purchase prices tend to be lower, target companies have not undergone optimization leaving more levers to pull to improve earnings, and there is a robust exit opportunity to larger private equity firms that often results in multiple expansion.²

Independent sponsors tend to focus on the lower middle market because the return potential is higher. Over 75% of transactions completed by independent sponsors from 2018-2021 had an enterprise value of less than \$50 million.³ This investment size is below the purview of most intermediaries (and therefore, most buyout funds), offering a differentiated and attractive opportunity set that complements a mature buyout program. We have observed that size is not the only delineating factor: most opportunities sourced by independent sponsors are off-market and relationship-based, so they are often unseen by the broader investor universe.

Independent sponsors can offer a differentiated and attractive opportunity set that complements a mature buyout program.

Careful selection of independent sponsors is critical given the vast dispersion of ability and outcomes among those seeking capital. But we believe—and data has shown—that the upside justifies the additional risk. Small cap buyout transactions broadly have shown much wider dispersion than large cap buyout according to the Cambridge data shown in **Exhibit 2**. Of the small cap transactions represented in the data (which they define as enterprise values <\$250 million and which includes deals completed by both funded and independent sponsors), approximately 13% of investments generated a 5x+ return, which compares favorably versus large cap transactions where only 5% produced the same result. However, small cap transactions also produced more losses, implying that selection is critical. A separate independent sponsor-only survey by Citrin Cooperman found that 15% of survey participants had an average realized Multiple on Invested Capital (MOIC) of >5x, and 43% had an average MOIC >3x (as compared to 13% reporting >5x and 34% reporting >3x in the aforementioned Cambridge data, which also included funded sponsors).⁴ Assuming the Citrin survey more explicitly represents the independent sponsor universe, this would indicate that independent sponsor investments have even more upside potential than the broader small cap universe tracked by Cambridge. The data aligns with our own experience: inefficient areas of the market are fertile hunting grounds for returns, so we view our independent sponsor program as a source of potential right-tail outcomes within our buyout portfolio.²

Exhibit 2

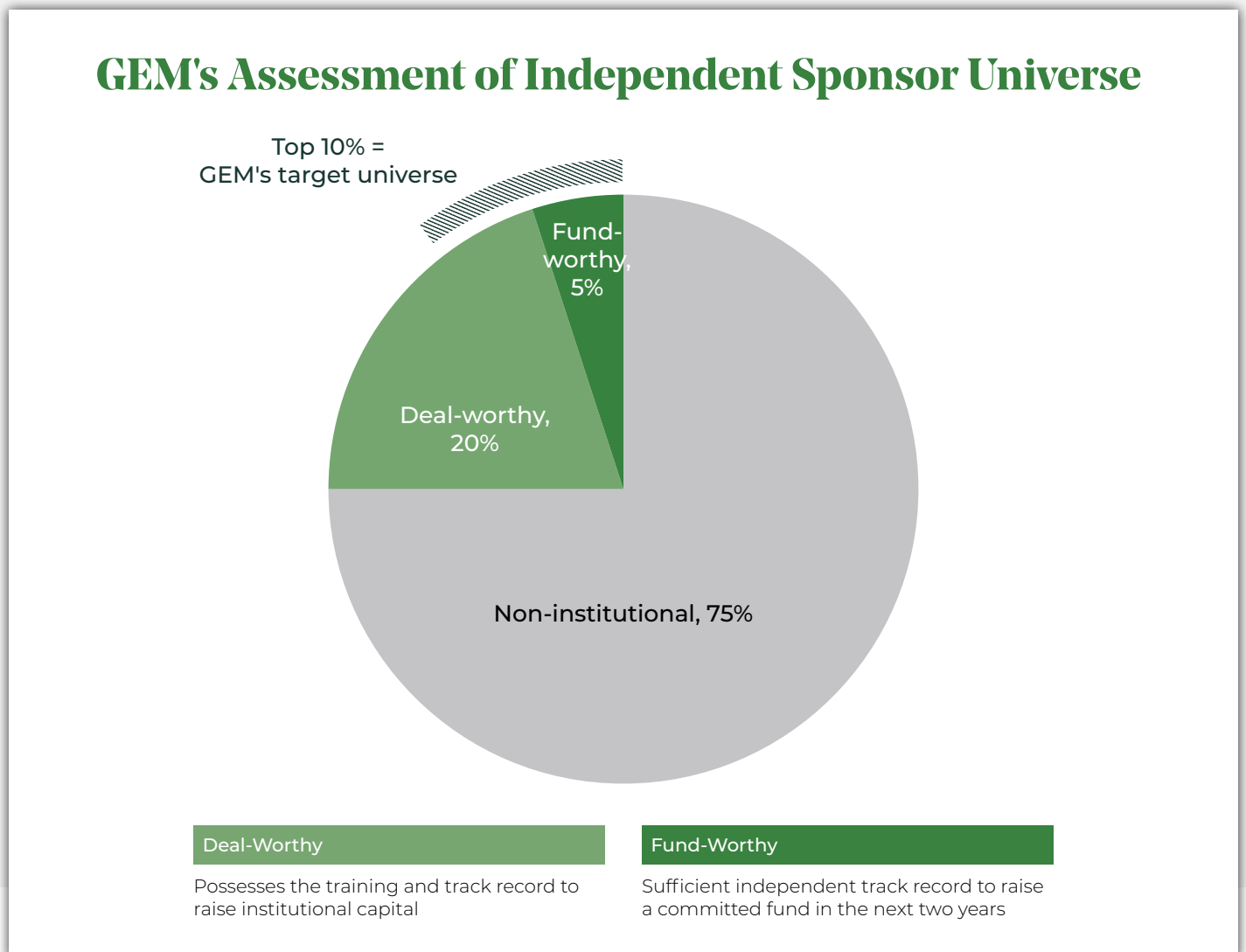


Source: Cambridge Associates LLC Private Investments Database. Size as of 12/31/2020; returns as of 3/31/2022.
 Notes: Chart represents the percentage of deals that fall within each MOIC cohort. Universe includes 1,656 fully realized US-based buyout and growth equity companies acquired from 2000-2020. Company size based on enterprise value at acquisition. Small cap = enterprise values <\$250 million (n=999); mid cap = enterprise values from \$250 million to \$1 billion (n=414); large cap = enterprise values >\$1 billion (n=252).

Opportunity Set

There is a robust and growing universe of independent sponsors. While we are not aware of a reliable data set that tracks the entire market, we believe that the annual McGuire Woods Independent Sponsor conference can serve as a reasonable proxy.⁵ The first conference was hosted in 2017 and had approximately 300 total attendees. By 2022, it had more than tripled in size with over 1,000 attendees, of which 477 were independent sponsors. In 2023, the number of independent sponsors nearly doubled again, with 843 firms registered. Of those groups, we estimate that ~75% do not yet have the training or track record to attract meaningful institutional capital and are looking for another funded sponsor to commit capital to their opportunity and assist with post-investment execution. We estimate that approximately 25% of the market is institutional quality, meaning they are experienced private equity investors with the networks and skills to both source and execute on investments independently. We estimate that 5% have a sufficient track record to raise a committed fund in the next two years. We view this as our target universe, as demonstrated in **Exhibit 3**.

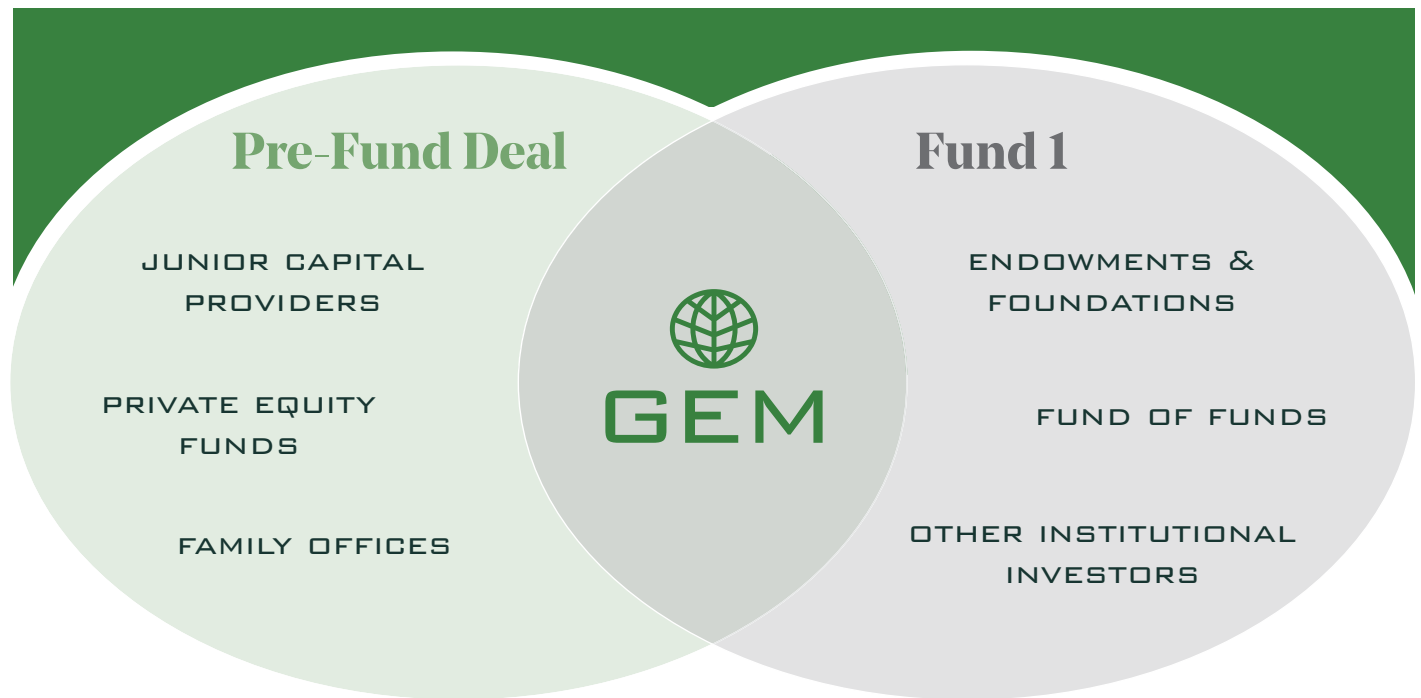
Exhibit 3



The primary pain point that we hear from independent sponsors is the uncertainty around capital raising for their next investment. The number of investors interested in the independent sponsor market is far smaller than the fund commitment market because the former is labor intensive and requires significant resources to source and execute well. The vast majority of investors supporting the independent sponsor market approach it as a co-general partner (co-GP), meaning they view the independent sponsor as a deal flow source and want to be heavily involved in due diligence and post-close decision making. Co-GPs include family offices, private equity firms, certain fund-of-funds, and private debt firms. The last group will often invest equity in conjunction with a lending commitment and require significant controls and decision-making rights. Yet a small minority of investors—including GEM—approach the independent sponsor market as an LP, meaning they intend to form an investment relationship with the independent sponsor and not just cherry-pick investments based on their selection criteria. We have found that a deal-by-deal investment relationship provides excellent perspective for a future fund commitment.

Exhibit 4

Capital Partner of Choice



Investing in the independent sponsor space successfully requires a larger volume of resources for both sourcing and diligence and the right mix of allocator and direct-investment experience. We believe the LP model described above is the most attractive option to independent sponsors, as this type of investor can offer continuity of equity capital, bridging the gap between initially backing them as an independent sponsor and later committing to a future fund.

Investing in the independent sponsor space requires significant resources.

GEM's Approach

Since 2015, GEM has been investing alongside independent sponsors and has built what we believe is one of the largest independent sponsor programs in the U.S.

As a traditional LP, we take a sponsor-centric approach to our due diligence process, leading with our strength and experience as underwriters of people to evaluate the merits of the proposed transaction. We leverage our team members' past experience in private equity to assist with investment diligence as well, while overlaying our own judgment of the sponsor's capabilities. But unlike a co-GP partnership, we rely on the sponsor to execute the deal and to implement their value-creation plan with the portfolio company post-close.

In the context of our broader buyout portfolio, our independent sponsor program has generated some of our highest quality Fund I opportunities.⁶ We believe that investing alongside a sponsor is the most thorough diligence that one can perform prior to committing to a fund: There is no better way to learn how sponsors underwrite, operate, and behave than by watching them navigate in real-time the range of issues that can arise with active portfolio companies.

Many of our independent sponsor relationships have transitioned into fund relationships over time. Because we already have a relationship with the sponsor, we're often able to serve as a thought partner on the fundraise, secure our desired allocation, and negotiate more investor-friendly terms. Below we've included two case studies featuring independent sponsors who have graduated from our program to become fund relationships.

Case Studies

Big Buyout Skillset in the Lower Middle Market

We met this sponsor after they left their prior firm—a well-known, multi-billion-dollar private equity firm—where the sponsor was a Managing Director for over a decade. This sponsor focuses on special situations and corporate carve-outs, a strategy that relies on speed and certainty of equity capital—two things that rarely exist for an independent sponsor. We engaged on their first investment opportunity, but ultimately passed on making the investment and instead used the process as initial due diligence. When a second opportunity arose for a take-private transaction that required the sponsor to provide an equity commitment letter in short order, we were well-positioned to move quickly and speak for the entire check. We think that our approach of conducting diligence on sponsors upfront widens the funnel to include opportunities that are not typically a fit for the independent sponsor model. After completing two additional investments together—a corporate carve-out and a merger of two businesses—we engaged in their committed fundraise. Through our pre-fund relationship we learned that their secret sauce is the “big fund” industry connections that led to both superior sourcing of opportunities and the ability to recruit high-quality executive talent to their portfolio companies. Had we not engaged with this sponsor pre-fund, we may not have been as well-positioned to participate in their Fund I.

Unique Insights and Advantaged LP Position

This sponsor approached us while they were aiming to raise a committed vehicle for their consumer-focused lower middle market fund. The sponsor was a former operator-turned-investor and had made a few investments but was too early in their lifecycle for us to make a commitment to a fund. We saw promise in their ability to leverage their unique relationships with retailers and buyers to grow small consumer businesses and encouraged them to pursue the independent sponsor route. We underwrote them for our program and made four total investments on a deal-by-deal basis. Through our involvement in those investments, we watched the sponsor iterate and improve on their strategy over time, doubling down on the types of investments where they had a clear edge. When they elected to raise Fund I, we were their first call and secured our desired capacity with an anchor commitment and favorable terms. Now, when additional co-investment opportunities arise, we are a preferred partner because the sponsor understands our co-investment process from our pre-fund relationship.

Conclusion

We believe that GEM has developed one of the largest institutional programs for backing independent sponsors and we remain bullish on the opportunity set today. In our view, the overall acumen and experience of individuals operating in an independent sponsor format is at an all-time high. These conditions present a compelling opportunity for investors who are seeking to gain access to high-quality investments that have the potential to deliver outsized returns as part of a holistic portfolio.²

About GEM

GEM is a leading provider of institutional investment solutions for endowments, foundations, sovereigns, families, and other long-term investors. Since 2007, GEM has specialized in delivering the highest quality service and support to our clients, enabling them to achieve their long-term investment goals. With a global reach, broad investment capabilities, and an experienced team, GEM strategically tailors solutions to meet the unique needs of each investor we serve.

For more information, visit www.geminvestments.com.

Endnotes

¹ Cambridge Associates LLC Private Investments Database. Size as of 12/31/2020; returns as of 3/31/2022. See Exhibit 2 on page three of this whitepaper.

² Returns are not guaranteed.

³ McGuireWoods [Independent Sponsor Deal Survey Summary & Analysis](#).

⁴ Citrin Cooperman [2023 Independent Sponsor Report](#).

⁵ Based on our observations, McGuire Woods hosts the most widely attended US independent sponsor conference.

⁶ As of 9/30/2023.

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