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Why Sponsors Matter (Fourth of a Series)

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Given all the benefits of having a private equity firm as your partner, why would you even finance a company without one? We put that question to Brett Hickey, the CEO of Star Mountain Capital, who specializes in this sector.

“There’s a lot of hype around non-sponsored transactions,” he told us. “It’s definitely buyer beware. If you’re a lender to these companies, there are many considerations you should keep in mind:

“First, do you have the expertise to do the additional due diligence to assess the operational, industry, management, legal and other risk-reward aspects of the company without the benefit of an experienced private equity sponsor?

“Second, do you have the operational resources to help develop or replace the management team, if necessary?

“Next, do the current owners have additional capital to support the company if it faces challenges? If not, does your firm?

“Does the borrower have the financial sophistication to execute its business plan? If you’re financing an acquisition, has the management ever made executed one? No matter the size, these require meaningful integration planning and management.

“Finally, is the exit strategy for your loan aligned with the business owners’ plan?”

But can you get compensated enough, we wondered, for all this extra work and risk?

“Investors focus on the fact that leverage multiples are lower, financial covenants tighter, and spreads higher,” Brett said. “But for those higher rates to materialize, you need much stronger underwriting and ongoing portfolio management capabilities.”

Another top debt manager who invests in non-sponsored loans agrees. “Does the management team have a history of handling leverage and behaving properly when issues arise?” he said. “The stories may be simpler than sponsored deals, but you have to check more operational boxes. For example, is the back-office institutional?”

One senior portfolio manager with significant non-sponsored experience said sector focus was critical. “We prefer companies that don’t face secular headwinds. If you’re investing at the top of the capital stack, unless it’s an over-leveraged cyclical, you should get paid back. But the “Five C’s of Credit” are even more a focus than usual.”

Finally, another CEO of a leading direct lender to non-sponsored corporates zoomed in on liquidity as his top concern. “Because there’s no sponsor with deep pockets to provide a liquidity safety net, we want to ensure that the borrower has sufficient capacity to carry it through any cash crunches. We track working capital like a hawk!”

Next week we look at lending to companies backed by non-traditional sponsors.