

Why Sponsors Matter (Last of a Series)

THE LEAD | October 12, 2016

So far in this special series we've examined the implications of lending to companies owned by private equity sponsors – and those that aren't. But there's a third category of owners that don't get much attention, and growing in importance.

So-called “fundless” sponsors – also called independent, or non-traditional sponsors – act as a hybrid of three parties. They combine the deal sourcing of investment bankers with the targeted allocation of capital by limited partners, and the expertise of GPs who perform a multitude of functions designed to enhance business performance.

As “fundless” implies, this class of owners does not rely on large vehicles raised from LPs designed to invest in a number of platforms over several years. Instead, independent sponsors round up investors on a deal-by-deal basis. They also invest personal dollars into the company for a significant equity share – often 20%.

The obvious risk for lenders is that independent sponsors do not have the reserve capital already allocated within a large fund for additional investments. This becomes vital in turnaround situations. Also, because the ownership of these companies is often split among a number of LPs, corporate governance can be a challenge.

And as one experienced lender told us recently, not all independent sponsors are created equally. Some have decades of experience successfully managing businesses across a broad range of industries. Others do not. Lenders must focus their due diligence on the track record of the sponsor as well as on the borrower.

Similarly not all “sponsored lending” is the same. This point was made to us by a top CEO of a leading middle market firm who has read our series with interest.

“Sponsored lending is a very different dynamic in the middle market compared with the broadly syndicated market,” he told us. “We are ‘buy and hold’ investors, so arrangers need to bring all the lenders along. Our investment approach governs.”

“In the broadly syndicated world, the reverse is the case. The large, liquid, trading-centric market emphasizes successful distribution. It's a sell-side model versus a buy-side one.”

But isn't bank regulation slowing that down, we wondered?

“Leveraged Lending Guidance has helped,” he said. “But it's still a sellers' market for syndicated loans. Sponsors are still paying significant underwriting fees. From a fiduciary perspective, sponsors need to make sure they are getting as much value as they can.”

“There's plenty of fund appetite out there right now. Even for close to 7x leverage cov-lite deals. Because the large bank arrangers aren't holding much paper, they're not as sensitive as middle market arrangers. In our clubby world, ‘buy-and-hold’ lenders have more leverage and incentive to draw the line when things get frothy.”