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# Deal Points

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# The New Cowboy: Relationships Trump Cash in Private Equity and the Rise of the Independent Sponsors and Searchers

CLARE LEWIS *Partner* CHARLES MCCARTHY *Associate*, Whiteford, Taylor & Preston LLP

## INTRODUCTION

Billions of private equity dollars are chasing fewer and fewer attractive opportunities. The ability to write checks and the size of those checks have exponentially increased, but success in buying opportunities has become increasingly scarce. In the past decade “*fundless sponsors*” once a pejorative term for the “*have-nots*” of the private equity world, have proven that sellers will sell their company to Butch Cassidy and endure a Wild West deal process of selling their company when the check might be written in the morning of the transaction after weeks or months of diligence and tens or hundreds of thousands in deal fees have already been incurred.

For sub ~US\$4M in Earnings Before Interest, Taxes, Depreciation, and Amortization (“**EBITDA**”) businesses, we see Entrepreneurship Through Acquisition (“**ETA**”) come into play with a searcher who is, many times, a lone individual who operates a company they acquire relying on Small Business Administration (“**SBA**”) or other similar small

loans for financing. For the greater than US\$4M EBITDA target company, an independent sponsor acts as an investor, not an operator, acquiring larger companies with a management team in place and leveraging private debt. The ETA model focuses on the individual’s entrepreneurial role within the business, while the independent sponsor model focuses on sourcing and providing capital for a portfolio of companies through deal-by-deal investments (rather than through a committed fund), with professional managers or existing leadership teams responsible for running the sponsor acquired companies.

As it turns out, access to cash is much easier than finding viable buying opportunities. Through relationships with accountants, financial advisers, lawyers, bankers, family members and a relentless ability to solicit, cajole and court potential sellers, sponsors are finding opportunities that elude traditional fund managers. Sponsors do all this with significantly less resources and contractual restrictions. How are they doing it; and what does this mean for the M&A world in a post-ChatGPT-4 era?



## ETA MODELS

There are primarily two different ETA models with variants: (1) a traditional search fund model, and (2) a self-funded search model, as discussed below.

### Traditional Search Fund Model

In the traditional search fund model, the searcher raises capital from one or more financial sponsors, such as a family office or a private equity firm, to search for target companies over a short period of a couple years. In exchange, the searcher forfeits some level of control and economics for the cash. The searcher may receive a salary during the search period which is necessary for less experienced or well-heeled searchers, but the trade-off is steep. The searcher gives up the majority ownership stake in the target to the sponsors and keeps only around 25% of the target company. Even more challenging if the sponsor(s) and searchers don't have clear lanes, the sponsor(s) may play a large role in the investment decision. Additionally, the investors are not required to invest additional capital once a target is identified by the searcher. Equity participation varies by deal and relationship but is generally less than in the self-funded model and may require vesting. Furthermore, in many governance arrangements between searchers and investors, the searcher can be removed as CEO by their investors post-acquisition. Typical targets in traditional search fund deals have EBITDA ranging from US\$1 million to US\$5 million and trade at valuation multiples between 4x and 8x EBITDA.

Another variant of this model occurs in accelerators, particularly in the academic setting, where a less experienced searcher without personal capital and little to no M&A or private equity experience joins an accelerator program or similar cohort that provides salary, office space, and resources over a short period to accelerate the search. The same trade-off exists in this model. The cohort/accelerator provides cash to fund the deals and, in exchange, expects a larger level of control and majority equity ownership of the target. The searcher may also be subject to equity

vesting tied to milestones to hit their target equity ownership percentage or risk forfeiture of their equity for cause. A searcher is not born a cowboy, they become one.

### Self-Funded Search Model

The self-funded search model is more cowboy with no salary during the search, more risk and more upside. These lone riders typically target companies with an EBITDA between US\$500,000 and US\$2 million, acquired at multiples of 3x to 5x EBITDA. Gen AI allows self-funded searchers to scrape the internet for potential acquisition targets at scale, automating the identification of acquisition targets. While some deals are sourced through off-market outreach using these tools, the majority of successful acquisitions still come through traditional relationship-driven channels and local business brokers. To fund the acquisition self-funded searchers typically use a combination of a SBA 7(a) loan, seller financing, a personal equity investment of at least 10% of the total project cost (required with a SBA 7(a) loan), and external investor equity capital. Typically, the deal is funded with a majority SBA 7(a) loan, minority seller note and personal capital and external equity investments. As such, the searcher can retain more control and equity upside (majority or even 100% ownership). Sellers retaining equity in SBA-backed transactions have become less common due to recent SBA guidelines requiring sellers to personally guarantee the loan for two years if they retain any ownership. For all searchers taking out an SBA loan, the government requires a personal guarantee for anyone with 20% or greater ownership. For this reason, investors in self-funded ETA deals typically stay below the 20% ownership threshold and usually collectively make up between 10-20% of the cap table with the remaining equity held by the self-funded searcher. Here, a self-funded searcher's payday can be gold rush good, but if things go south, the ranch might be riding off into the sunset.

## Independent Sponsor Model

Pejoratively known as finders who couldn't raise a fund, independent sponsors have carved out a cowboy class of their own, affirmatively choosing to remain independent sponsors to keep their freedom and avoid the expensive process involved in raising a blind pool fund and the restrictions that come along with the fund. Most independent sponsors have a long and successful track record in private equity, M&A and investment banking, along with deep industry expertise network, with cream of the crop known for having ice in their veins as they navigate deals on a deal by deal basis. Sellers see the value that independent sponsors can add with operational efficiencies and access to new markets post-closing and trust that they'll have the ability to wire the cash on the closing day.

The typical economics are as follows:

### 1. Annual Management Fee:

- a. 3-5% of target TTM EBITDA, paid quarterly in arrears
- b. Subject to hard dollar floor and cap, e.g., US\$250,000 to US\$750,000, with less experienced sponsors subject to smaller caps and no floor

### 2. Promote/Carried Interest:

- a. Base of 10% to up to 20-30% carry upon the achievement of certain hurdles
- b. For example, a 10% base carry can increase as follows:
  - 15% carry above 1 to 2 times multiple of invested capital (MOIC) and 8% preferred return
  - 25% carry above 2 to 2.5 times MOIC and 8% preferred return
  - 30% carry above a 2.5 to 3 times MOIC and 8% preferred return
  - Sponsors may also get a catch up

### 3. Closing fee:

- a. 1-5% of enterprise value, subject to a hard cap and floor
- b. Fee may be rolled into the sponsor's equity investment in the portfolio company
- c. Note federal and state securities law may limit a sponsor's ability to accept success-based transaction fees

Other Terms:

#### 1. Control:

- a. Board seat
- b. Information rights
- c. Requirement of sponsor to devote sufficient time and attention to portfolio companies
- d. No competitive activities

#### 2. Vesting:

- a. Equity vesting is not typical
- b. Promote forfeiture- if sponsor is terminated for cause or disassociated without good reason

Harmonizing the economic relationship between the independent and equity sponsors is always the trick. Cash comes with economic and autonomy strings, but the sponsors have alignment - close the deal quickly and get off to the races making money for everyone. M&A practitioners need to keep up and in partnership with the sponsors, take risks (primarily in broken deal fees) and get the deal done quickly and efficiently.

In an era where capital is abundant, but quality deals are scarce, relationships, not cash, remain the true currency. Independent sponsors and searchers are proving that grit, hustle, and personal networks can outperform institutional checkbooks in the race to source and close deals. Whether backed by deep industry experience or sheer entrepreneurial determination, these modern cowboys are reshaping the landscape on their own terms.