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Office Association

A FAMILY OFFICE GUIDE FOR DIRECT INVESTING VIA INDEPENDENT SPONSORS

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A Family Office Guide for Direct Investing via Independent Sponsors

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Abstract

This whitepaper examines the growing trend of direct investing by family offices, particularly through partnerships with independent sponsors. As family offices seek to bypass the fee drag and limited control of traditional private equity funds, direct investing is increasingly being seen as a compelling alternative. We explore the mechanics of independent sponsor transactions, the pros and cons for family offices, some global trends, and key legal and governance considerations. Hopefully, by better understanding these dynamics, family offices will be able to make informed decisions to adjust their investment strategies and achieve their goals.

Introduction

The private equity landscape is seeing increasing involvement by family offices in direct investing. Several recent reports highlight this trend. For example, the North America Family Office Report (2024) by Campden Wealth and RBC suggests that 60% of family offices are involved in direct private equity investments, with many planning to increase their allocations. A recent survey by Bastiat Partners and Kharis Capital suggests half of family offices plan to undertake direct deals in the next two years. And, according to the Dentons Family Office Direct Investing Survey (2022), 63% of family offices engage in direct investments, with many others expressing interest in this approach. Lastly, a Citi Private Bank 2021 survey found that 76% of family offices had at least 10% of their portfolios in direct – signaling “a shift away from conventional methods” of commingled funds.¹

Traditionally, family offices have relied on commingled funds, with blind-pool capital, managed by general partners, who charge annual management fees plus a carried interest – typically a 2% management fee, and 20% carried interest (“2 and 20”). However, dissatisfaction with these fees, for mediocre performing managers, coupled with a desire for greater control and alignment with investment objectives, has led many family offices to explore direct investing.

Direct investing allows family offices to invest directly in private companies, often in collaboration with independent sponsors — typically experienced dealmakers who source and structure transactions without a pre-existing fund. This model usually provides family offices with the opportunity to participate in investments on more favorable terms, with enhanced control over decision-making processes and the potential for higher returns. This whitepaper aims to provide a comprehensive overview of direct investing through independent sponsors, highlighting its advantages, operational mechanics, and strategic considerations for family offices.

Evolution of Private Equity Models

The history of private equity can be traced to 1901, when J.P. Morgan—the man, not the institution—purchased Carnegie Steel Co. from Andrew Carnegie and Henry Phipps for \$480 million. More recently, the private equity blind pool model pioneered by KKR, among others, in the mid-1970s has dominated the industry. In this model, limited partners (LPs) commit capital to blind-pool funds managed by general partners (GPs), who charge a management fee (typically 2% of committed capital) and carried interest (usually 20% of profits), typically above a preferred return hurdle. This structure provided LPs with access

[1] The range -- from 60% to 76% -- quoted in these surveys reflects the lack of standardization around definitions and nomenclature within the family office world but directionally suggests that family offices are allocating significant capital to direct private equity opportunities.

to private markets but came with limitations, including significant fees, a lack of control over investment decisions, and potential misalignment of interests. Family offices are increasingly turning to direct investing due to their growing scale and expertise, a preference for greater oversight and privacy in their investments, and frustrations with the traditional fund model's lack of alignment. Conventional private equity funds often prioritize quick exits or fundraising objectives that conflict with the long-term goals of family capital. Through direct investments, whether independently or in collaboration with others, families can choose their target companies and actively manage their involvement. The rise of direct investing reflects a broader trend towards professionalization within the family office space, with private equity remaining a favored asset class (PwC, 2024).

Thus, motivated by the desire to reduce fees, gain more control, and invest in sectors aligned with their expertise, many family offices are choosing to invest directly in private companies. This shift is facilitated by the emergence of independent sponsors, who offer a flexible, deal-by-deal approach to private equity investing.

Independent Sponsors: Definition and Operation

Independent sponsors, also known as 'fund-less sponsors', are individuals or small teams with extensive experience in private equity or investment banking. Unlike traditional GPs, they do not manage a dedicated fund; instead, they identify investment opportunities, negotiate deals, and then raise capital from investors on a per-deal basis. The process typically involves the following steps:

1. **Deal Sourcing:** Independent sponsors leverage their networks and industry knowledge to identify potential acquisition targets.
2. **Due Diligence and Negotiation:** Upon identifying a target, the sponsor conducts preliminary due diligence and negotiates a Letter of Intent (LOI) with the seller.
3. **Capital Raising:** After signing the LOI, the sponsor has a specified period to raise the necessary capital from investors, such as family offices, to complete the transaction.
4. **Closing and Management:** If capital is successfully raised, the deal closes, and the sponsor, along with the investors, takes ownership of the company. The sponsor often plays an active role in overseeing the investment, such as serving on the board, while the company's management team handles day-to-day operations.

The independent sponsor does not typically take an executive role in the acquired company – unlike a search fund entrepreneur – but rather oversees the investment as a board member. The company's existing management is typically retained and often augmented with new talent to help grow the business.

Compensation for independent sponsors is structured to align their interests with those of the capital providers. Common components include:

- **Monitoring Fees:** Typically, 3% to 5% of the company's EBITDA, paid quarterly, to compensate the sponsor for ongoing management and oversight. This contrasts with traditional private equity funds, where management fees are charged to the fund regardless of portfolio company performance.
- **Carried Interest:** A share of the equity gains, ranging from 10% to 30%, often tiered based on performance thresholds. This ensures that the sponsor benefits only after investors achieve a certain return.

This performance-based compensation model contrasts with the traditional “2 and 20” structure of private equity funds, where fees are charged on committed capital regardless of deployment. The independent sponsor model ties fees directly to the success of each deal, fostering a strong alignment with investors. Consider a simplified example: An independent sponsor sources a \$50M enterprise value deal funded with \$25M equity and \$25M debt. A family office provides 100% of the equity, and the sponsor earns a 2% closing fee (\$1.0M), rolling half into the deal. The independent sponsor also receives a \$250K annual monitoring fee. After 5 years, the company sells for \$100M. The family office receives its original \$25M back, an 8% compound, preferred return (~\$11.7M), and 80% of the remaining profits (\$30.6M). The sponsor earns approximately \$7.7M in carried interest, bringing their total to around \$9.7M across fees and carry. A significant majority of the sponsor's upside is closely tied to the deal's performance—aligning interests closely with investor.²

According to McGuireWoods, the majority of independent sponsor deals take place in the lower middle market, with approximately three-quarters of transactions involving companies valued up to \$75 million. Notably, over two-thirds of these deals involve firms with enterprise values below \$50 million, a segment often bypassed by larger private equity players. These smaller enterprises, typically family- or founder-led with EBITDA under \$10 million, pose unique challenges in due diligence and operations that major funds tend to sidestep. Independent sponsors who tackle the demanding tasks of identifying and enhancing these businesses can achieve substantial returns in a market segment that traditional private equity has largely ignored.

Evidence suggests that independent sponsors are increasingly involved in larger transactions. Holland & Knight reports that a growing number of these sponsors are handling middle-market deals, with company valuations typically between \$100 million and \$500 million. This trend highlights the growing sophistication of the independent sponsor framework and heightened trust from funding sources. For example, Global Endowment Management secured more than \$450 million to finance independent sponsor-led deals, signaling robust institutional support for these larger-scale investments.³

[2] See Appendix A for step-by-step calculations.

[3] Holland & Knight. (2023). Independent Sponsors: Market Trends and Industry Insights.

This trend is further supported by the increasing number of independent sponsors in the USA, estimated at around 1,300, many of whom are leveraging their deal-by-deal track records to transition into traditional fund structures. The Wall Street Journal notes that Coalesce Capital secured \$900M for its first fund and Agellus Capital raised \$400M after securing an anchor investor early in the process. As independent sponsors continue to demonstrate their ability to source and close larger transactions, the model is steadily moving into the mainstream of middle market private equity.⁴

Potential Benefits for Family Offices

Independent sponsor transactions are commonly financed through networks comprising family offices, high-net-worth individuals, and dedicated investment funds. Current data indicates that family offices represent the primary source of capital for these deals.⁵

Direct investing through independent sponsors offers several key benefits to family offices:

- **Cost Efficiency:** By avoiding the management fees and carried interest of traditional funds, family offices can retain more of the investment returns. This is particularly appealing given the high perceived costs associated with the traditional model, although these costs, while not borne directly, do still come out of the return to the investor.
- **Control and Flexibility:** Family offices have more influence over investment decisions, including the selection of sectors, holding periods, and exit strategies. This allows them to align investments with their expertise and long-term goals.
- **Alignment of Interests:** The partnership model ensures that the sponsor's incentives are closely aligned with those of the family office, as both parties share in the success of the investment. Where the alignment is strongest is the management fee charged to the portfolio company based on performance rather than charged to LPs based on commitments.
- **Access to Niche Opportunities:** Independent sponsors often focus on specific industries or deal sizes, providing family offices with access to unique investment opportunities that may not be available through traditional funds.

These benefits make direct investing an attractive option for family offices seeking to optimize their private equity portfolios. However, despite these advantages, direct investing is challenging for family offices, especially smaller ones. Doing direct deals requires capabilities in deal sourcing, due diligence, execution, and asset management that many family offices lack or are unwilling to build. Many family offices operate lean (a CIO and a few analysts) and cannot easily vet deals across various industries on tight timelines.

[4] WSJ, "Private Equity Managers Persevere In Pitching First-Time Funds"

[5] In a 2023 survey, 63% of independent sponsor deals involved family office capital – the highest of any source. Other top sources included mezzanine funds (often providing equity co-invest alongside debt; involved in ~50% of deals) and high-net-worth individuals (~47%) (tiff.org). Note: this data cites occurrences rather than dollar volume, which may be lower for family offices versus institutional investors.

Global Trends in Direct Investing

The adoption of direct investing by family offices is a global phenomenon, with variations across different regions⁶:

| Region | # of SFO's | Key Trends |
|---------------|------------|---|
| North America | 3,180 | 83% engage in private equity, often through direct deals (Deloitte, 2024). |
| Europe | 2,020 | Cultural preference for direct ownership, leading to co-investments. |
| Asia-Pacific | 2,290 | Rapid growth, favoring growth equity and venture deals with local sponsors. |
| Middle East | 290 | Diversification from oil-based economies through direct investments. |

- **North America:** As the largest market for family offices, North America leads in direct investing, with significant assets under management (AUM) and a strong preference for private equity (Deloitte, 2024).
- **Europe:** European family offices, driven by a cultural inclination towards direct ownership, increasingly participate in co-investments and partnerships with independent sponsors.
- **Asia-Pacific:** The region is experiencing rapid growth in family offices, particularly in China, Hong Kong, and Singapore, where there is a focus on growth equity and venture deals, often in collaboration with local sponsors or conglomerates.
- **Middle East:** **Emerging wealth hubs like Dubai and Abu Dhabi are attracting family offices seeking to diversify through direct investments in various sectors.**

These regional differences highlight the adaptability of the direct investing model to diverse market conditions and investment preferences.

[6] Campden Wealth/RBC North America Family Office Report 2024.

Governance and Operational Considerations

Engaging in direct investing requires family offices to navigate complex legal, governance, and operational landscapes. Unlike a commingled fund where an LP is hands-off, here the family office and sponsor effectively become business partners in a single-company investment. Key considerations include:

- **Partnership Agreements:** Clear agreements with independent sponsors regarding fees, interest, governance rights, and operational roles are essential to ensure alignment and prevent conflicts.
- **Due Diligence:** Family offices must conduct thorough due diligence on both the investment opportunity and the independent sponsor's track record, expertise, and reputation.
- **Regulatory Compliance:** Compliance with regional regulations, such as securities laws and tax implications, is crucial to avoid legal pitfalls.
- **Risk Management:** Direct investments entail higher risks due to concentrated exposure; robust risk management frameworks are necessary to monitor and mitigate potential downsides.

Securing an appropriate partner presents significant challenges. Independent sponsors frequently find it difficult to establish connections with family offices, which often maintain a discreet presence and avoid prominent networking gatherings. Connections are typically facilitated through trusted intermediaries such as private bankers, lawyers, or investment advisors familiar with a family's investment preferences. Family offices, when considering partnerships with independent sponsors, often express concerns about: the sponsor's dedication (fearing a lack of commitment during challenging times), additional funding requirements (where reluctance to provide further capital can lead to conflicting priorities), and governance issues (with families typically seeking significant influence, such as board representation or veto powers, when providing the majority of capital).

Economic Comparison

Comparing the economics of traditional private equity funds and direct investing models reveals significant differences:

| Aspect | Traditional PE Funds | Direct Investing with Independent Sponsors |
|----------------------|--------------------------------|--|
| Fees | 2% management + 20% carry | Negotiated per deal, typically lower |
| Control | Limited for LPs | High, with influence over decisions |
| Flexibility | Fixed fund terms, forced exits | Flexible holding periods and exit strategies |
| Tax Alignment | Potential for phantom income | Tailored structures for better tax outcomes |

Direct investing allows family offices to tailor tax structures and focus on single-asset exposure, enhancing after-tax returns. However, it's worth noting that the lines are not black-and-white. Some large family offices continue to invest in top-tier PE funds for diversification, while also carving out a portion for directs. And some independent sponsors effectively operate like small funds (doing multiple deals in parallel and even raising “search funds” or pledges to cover their costs). Conversely, some PE funds now offer separately managed accounts or coinvest funds to single investors, blurring into the direct model.

Challenges and Risk Mitigation

While direct investing offers numerous advantages, it also presents challenges that family offices must navigate:

- **Finding the Right Partner:** Identifying and vetting independent sponsors with appropriate expertise and track record is crucial.
- **Building Trust:** Establishing trust with sponsors under tight deal timelines can be difficult; thorough due diligence and clear communication are essential.
- **Resource Intensity:** Direct investing requires significant time and resources for deal sourcing, due diligence, and ongoing management, which may strain smaller family offices.
- **Concentration Risk:** Investing directly in single assets increases concentration risk compared to diversified fund investments.

[7] Traditional PE Funds typically charge 2% management fee on committed capital, charged to the fund, plus 20% carried interest, plus monitoring fees (3-5% of EBITDA) charged to the portfolio company. Independent sponsor fees are negotiated per deal and typically include monitoring fees (3-5% of EBITDA) charged to the portfolio company, plus 10-30% carried interest.

To mitigate these risks, family offices can:

- **Develop In-House Expertise:** Build a team with the necessary skills or partner with experienced advisors.
- **Establish Clear Criteria:** Define investment criteria and partner selection processes to ensure alignment with strategic goals.
- **Diversify Investments:** Spread investments across multiple deals and sectors to manage risk.
- **Implement Robust Governance:** Set up strong governance structures to monitor investments and sponsor performance.

Implications for Stakeholders

The rise of direct investing impacts various stakeholders in the private equity ecosystem:

- **Limited Partners (LPs):** Traditional LPs may need to build in-house capabilities for direct investing or seek better terms from GPs.
- **General Partners (GPs):** GPs face increased competition from independent sponsors and may need to adjust their fee structures or offer more co-investment opportunities.
- **Deal Intermediaries:** Investment bankers and advisors benefit from an expanded buyer pool but must adapt to the unique requirements of family offices and independent sponsors.
- **Founders and Management Teams:** They gain access to flexible, long-term capital from investors who are often more aligned with their strategic vision. While they may be forced to accept longer sale processes and exclusivity periods, and take some risk of failure of financing, the benefit is a wider pool of buyers and most importantly the ability to align better when they are rolling equity (which is typical at this stage).

Conclusion

Direct investing through partnerships with independent sponsors represents a paradigm shift in how family offices approach private equity. By offering greater control, cost efficiency, and alignment of interests, this model enables family offices to optimize their investment strategies and achieve superior outcomes. At the same time, the line between independent sponsors and traditional GPs is being blurred by the emergence of hybrid structures and flexible capital strategies. Many first-time fund managers are simultaneously raising debut funds while deploying capital through co-investment pools, SPVs, pledge funds, or even permanent capital vehicles. These models blend the flexibility and performance orientation of deal-by-deal investing with the scalability of fund platforms. For investors, they may offer a dual benefit of more efficient, performance-tied fee structures and better tax alignment by linking recognition to actual distributions. As a result, the rigid GP/LP paradigm is giving way to a broader spectrum of capital deployment models—ranging from blind pools to single-asset partnerships—with family offices often leading the charge in adopting and shaping these innovations. In conclusion, while challenges exist, careful planning and execution can help family offices navigate the complexities and reap the rewards of direct investing. As the number of family offices continues to grow globally, those that embrace direct investing should be well-positioned to achieve their financial objectives and preserve wealth for future generations.

Appendix

To calculate the preferred return and related financial outcomes for the given private equity deal example, let's break it down step by step based on the provided information. Since the example does not explicitly state the preferred return rate or profit split, I'll assume similar terms to the previous example (8% compounded preferred return and 80/20 profit split) for consistency, as this is a follow-up question asking for the "same calculations." If different terms are intended, please clarify.

Key Details:

- Enterprise Value (EV): \$50 million
- Equity Contribution: \$25 million (provided by the family office)
- Debt: \$25 million
- Closing Fee: 2% of \$50 million = \$1.0 million (sponsor rolls half, \$0.5 million, into the deal)
- Monitoring Fee: \$250,000 per year
- Holding Period: 5 years
- Exit Value: \$100 million
- Preferred return: 8% per year, compounding annually
- Profit split: Family office receives 80% of remaining profits, sponsor receives 20% as carried interest

Step-by-Step Calculations:

#1. Preferred Return Calculation:

The preferred return is an 8% annual return, compounded annually, on the family office's \$25 million equity investment over 5 years using the formula: $A = P * (1 + r)^n - P$

- $P = 25,000,000$ (initial equity investment)
- $r = 0.08$ (annual preferred return rate)
- $n = 5$ (years)
- Calculate $(1.08)^5 = \sim 1.469328$
- Total amount including principal: $25,000,000 * 1.469328 = 36,733,200$
- Preferred return: $36,733,200 - 25,000,000 = 11,733,200$

#2. Total Return to Family Office (Capital + Preferred Return):

Family office receives its initial \$25 million equity back plus the preferred return: $25,000,000 + 11,733,200 = 36,733,200$

#3. Exit Proceeds and Remaining Profits:

- Exit Value: \$100 million
- Debt Repayment: \$25 million
- Equity Value at Exit: \$100 million - \$25 million = \$75 million
- Remaining Profits after family office receives capital + preferred return: 75,000,000 - 36,733,200 = 38,266,800

#4. Profit Split:

- Family Office (80%): $38,266,800 * 0.8 = 30,613,440$
- Sponsor Carried Interest (20%): $38,266,800 * 0.2 = 7,653,360$

#5. Sponsor's Total Compensation:

- Closing Fee: \$1.0 million (half rolled into the deal, so cash received = \$0.5 million)
- Monitoring Fees: $\$250,000/\text{year} \times 5 \text{ years} = \1.25 million
- Carried Interest: ~\$7.65 million
- Total Sponsor Compensation: $0.5 + 1.25 + 7.65 = 9.45$

#6. Family Office Total Return:

- Capital Returned: \$25 million
- Preferred Return: ~\$11.73 million
- Profit Share: ~\$30.61 million
- Total: $25 + 11.73 + 30.61 = 67.34$

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About the Author

Marc J. Sharpe is a global investment executive and board member with a distinguished career spanning family office management, private equity, venture capital, and investment banking. Known for his strategic insight, deep expertise in family office governance, and ability to foster innovation and value creation, Mr. Sharpe has built and led investment platforms that deliver sustainable growth while navigating complex financial and operational challenges. His leadership style emphasizes integrity, continuous improvement, and long-term partnerships that generate significant stakeholder value. Mr. Sharpe is the Founder and Chairman of The Family Office Association, a premier global peer network of single-family offices. Since 2007, he has cultivated a community of senior family office executives and principals representing some of the world's wealthiest families, promoting education, shared-best practices, and co-investment opportunities. Under his leadership, TFOA has become a trusted forum for collaboration, market insight, and proprietary investment deal flow on a global scale. He also teaches an MBA class on "The Entrepreneurial Family Office" as an Adjunct Professor at Rice University and Southern Methodist University. Mr. Sharpe holds an M.A. from Cambridge University, an M.Phil. from Oxford University, and an MBA from Harvard Business School.

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