Forbes http://onforb.es/11ZSRop

Brent Beshore Contributor

I provide a Midwest view on entrepreneurship, VC, and private equity.

Opinions expressed by Forbes Contributors are their own.

ENTREPRENEURS 12/04/2014 @ 10:53AM | 6,343 views

Acquiring Companies Without Money: The Rise of Fundless Search Models

If you're involved in deal-making professionally, chances are you've encountered search funds and fundless sponsors frequently this year. Although they were virtually unknown (or incognito) just a few years ago, fundless models seem to be cropping up in deal competition everywhere. Multiple factors have contributed to their popularity and competitive position in lower middle market acquisitions.

The Search Fund Versus the Fundless Sponsor

Unlike traditional private equity firms — where general partners raise funds from investors — fundless models operate with no committed capital with which to invest as equity in an acquisition. Since emerging in the early '80s, two basic fundless models have developed: the search fund and the fundless sponsor.

The model of modern search funds is broken down in a 2013 Stanford Graduate School of Business study, which collected data from 177 search funds. A search fund involves one or two principals targeting two to four industries for approximately two years with the intent to purchase one business and run its day-to-day operations post-transaction.

A search fund gets its name because principals raise $300,000 to $500,000 to fund the search. Once a target acquisition has been identified and is under a letter of intent, the principal(s) will go to search-stage investors and other sources to raise the equity needed to close the transaction.

In contrast, fundless sponsors operate more like traditional private equity firms. They consist of a professional management team that does not intend to take over direct day-to-day operations of an acquisition target.

Rather, fundless sponsors are usually adding to an existing portfolio. They may have previously raised a fund — the holdings of which may still be a part of the firm's operating portfolio. Fundless sponsors are generally experienced financial acquirers with known performance metrics on past investments and extensive capital-oriented networks.

What Factors Caused a Rise in Fundless Models?

From 1983 to 2008, fundless models were employed infrequently. In the past six years, however, several changes have caused a significant shift in popularity.

Regulation: When the Dodd-Frank Wall Street Reform and Consumer Protection Act was introduced, many would-be managing partners of private equity firms were confused by the changes in regulatory demands of fund managers. For example, the Volcker Rule — which prohibits banks from investing in private equity firms — made the challenge of raising funds seem even more daunting.

Although the increased regulatory burdens on funds haven't been nearly as severe as initially predicted, the perception sent some looking for alternative models.

Zombie private equity funds: In 2013, Preqin issued a report on "zombie funds," which were estimated to be tying up $116 billion worth of private equity assets in 1,732 portfolio companies. These funds were often holding

capital past its holding period, had no clear plans to raise a successor fund, and had an underperforming operating portfolio that disincentivized general partners to prepare exits.

Zombie funds can quickly disillusion limited partners, whose investment liquidity is being held captive while they are still paying management fees, which causes them to search for alternative models.

Would-be limited partners as competition: Traditionally, if you wanted to invest in private companies, you became a limited partner in a private equity fund. But between zombie funds, miscommunication or misjudgment by general partners, and generally lower-than-expected levels of returns, some would-be limited partners began abandoning the structure in favor of direct investment.

Private equity's competition — both in fundraising and deal-making — now includes the entities that traditionally funded its model, including sovereign wealth funds, large family offices, pension plans, and state-owned entities.

The inflexible nature of private equity funds: A fund is intentionally inflexible to maximize the model. Investors put capital into a collective pool over which they have limited influence and for which they must pay an annual management fee. General partners promise to deploy the capital in a relatively short time frame to return their investors' initial capital and gains within a reasonable time horizon. Often, the time horizon creates a difficult situation for both parties — long-term gains suffer for short-term liquidity while successive transition costs mount.

Fundraising challenges: There seem to be two options for would-be first-time fundraisers: They can either spend 18 or more months trying to raise a fund and then more time trying to make acquisitions that build a favorable long-term reputation for them as managers, or they can find a few investors to sponsor a search and spend 18 to 24 months finding one acquisition target. The latter equals less risk and, hopefully, a shorter time period to make an acquisition.

Advantages of a Fundless Model

While these factors made the acquisition environment ripe for alternative models, the question still remains: What makes a fundless model viable? To gain some perspective, I asked Clayton Collins of Riomar Capital, a search fund based in New York City, to share a firsthand perspective on why he chose the fundless model. Here are two key excerpts from our discussion:

Meeting the Principal's and Seller's Goals

My decision was less about launching a search fund and more of a choice of finding the right path to becoming the CEO of a successful private company and having a significant ownership stake in the business. Many lower middle market and family businesses are facing obstacles in succession planning and are looking for the next generation of management. By purchasing a business, I can provide financial liquidity to the business owners and solve the succession issue.

Entrepreneurs have a choice: start a company from scratch or acquire an existing business. Given my background and the current market, acquiring a business is the right strategy for me.

Flexibility in Structure

When it comes to structuring an acquisition, search funds have the flexibility to structure a deal to meet the specific needs of the business owners. Search fund managers and investors also take a patient approach to the investment time horizon, allowing the management team to plan for long-term growth and sustainability.

The flexibility of the search fund model extends to the financial structure and terms of the transaction. Ultimately, the financial structure will depend on the specific company characteristics, including the revenue model and cash flow margins.

Another benefit of the search fund model is the size and diversity of the investor group. If an investor doesn't like a deal, there is no obligation to participate. Other investors in the group will have the opportunity to provide a larger than pro-rata share of the acquisition capital, ensuring that investors with applicable operational and industry experience are involved in the transaction.

Outcomes of Fundless Models

As with all private deals, the data available on fundless models is limited.

The Stanford study provides some search fund reference points from its limited sample. Fifty-six percent of the funds studied successfully acquired a company while 20 percent quit their search altogether. In terms of deal size, 51 percent of companies were purchased for $4 million to $12 million. Of those that made an acquisition, 61 percent were still operating, 22 percent had since sold the company, and 17 percent had shut the company down.

Success can be found in the search fund model. The study found that search funds initiated by partners (rather than a single principal) yielded greater returns than those with a single principal. Using conservative assumptions, the aggregate pre-tax internal rate of return of the search fund asset class through year-end 2013 was 34.9 percent, and the aggregate pre-tax return on invested capital is 10 times. As with most models, a handful of big successes have helped to boost the available data, and thus, attraction to fundless models in recent times.

I'm an entrepreneur, the founder and CEO of adventur.es (No. 28 on the 2011 Inc. 500), an angel investor, a winemaker (Beshore Family Vineyards), a poverty relief advocate, and the husband to a Ph.D.

RECOMMENDED BY FORBES

7 Types of People Who Buy Main Street Businesses

EBITDA Is 'BS' Earnings

11 Key Questions Prospective Buyers Will Ask About Your Business

What Are Buyers Paying for Main Street Businesses?

The Most Expensive Home Listing in Every State 2016

32-Year-Old Creates New Foodie Fad, Wins On Shark Tank

The Cities With The Most Billionaires

Watch The Hyperloop In Action

This article is available online at: http://onforb.es/11ZSRop

2016 Forbes.com LLC™ All Rights Reserved