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# 'Fundless sponsor' deals gaining in private equity

## *Managers are taking on more investments pushed by specialist freelancers*

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David Alpern said independent executives help source proprietary deals.

A growing number of private equity executives without capital of their own to invest are finding deals and shopping them to other private equity firms.

And private equity firms are buying.

Private equity is a difficult business these days because debt is plentiful and competition for deals is causing prices to skyrocket. So, some private equity firms are getting deals they wouldn't otherwise have found from freelancers, many of whom are former private equity executives who are specialists in a region or industry, giving them access to deals the private equity firms might not otherwise find.

The number of so-called "fundless sponsors" has doubled from five years ago, estimated Michael B. Shaw, partner in the Chicago office of law firm Much Shelist PC, who helps put private equity transactions together.

"There are a lot of former private equity people who have left funds and elected to go alone, but they can't raise capital because they lack a track record," Mr. Shaw said.

At the same time, there are private equity firms that can't raise another fund and so their executives are leaving. They are striking out on their own searching for deals first and then for capital from other private equity firms.

Mr. Shaw said the number of fundless sponsors will increase.

"The availability of capital from traditional sources is not growing. There is less money allocated to a smaller number of private equity groups," he said.

That means there will be more former private equity executives available who will be searching for companies to buy and offering them up to the private equity firms that have capital to invest, Mr. Shaw said.

## Fewer investment pros

As of June 30, there are 1,049 funds that were raised between 2002 and 2007 managed by firms that have not successfully raised capital since 2007, according to Preqin, a London-based alternative investment research firm.

At the same time, the private equity industry is employing far fewer investment professionals than it did in 2008, said John Barrett, managing partner in the Boston office of executive search firm Cook Associates Inc., which helps find jobs for private equity investment executives.

Just last year, a Minnesota-based private equity firm backed an independent sponsor, who had worked in the oil and gas industry, in acquiring an oil field services company, he explained. He declined to identify the firms.

At least one institutional investor applauds the trend.

Taking advantage of one-off transactions "is one of the few inefficiencies in the domestic private equity market," said Jonathan Grabel, chief investment officer of the $14.6 billion New Mexico Public Employees Retirement Association, Santa Fe. New Mexico PERA has not invested in fundless deals because it lacks the resources to do the due diligence it would need to do in order to invest in them, he said.

However, Mr. Grabel said he has challenged firms that put together co-investment funds to create a fund of fundless sponsor deals, but none has.

"If there is a way for institutional investors to institutionalize the fundless business, I think there is potentially a way to have risk-adjusted, outsized returns," Mr. Grabel said.

One advantage is the investor would avoid many of the fees associated with a commingled private equity fund. There also would be a better alignment of interest between the fundless sponsor and investors.

"If someone is doing one deal, that deal cannot fail. The impact would be too much," Mr. Grabel said.

Rich Lawson, CEO and managing partner of HGGC LLC, a Palo Alto, Calif.-based middle market private equity firm, estimated three or four deals of the 10 transactions the firm is targeting for its current $1.1 billion fund came from fundless sponsors, also simply referred to as brokers.

"A lot of people are spinning out of shops," Mr. Lawson said. "A lot of people are out there trying to put a few deals together in order to raise a fund. It is happening a lot."

These executives help provide private equity firms something they need — access to proprietary deal flow.

"It is something we've seen because there are many credible deal professionals (and/or consultants) out there with both category experience and valuable industry relationships," said David Alpern, a partner in the Los Angeles office of private equity firm Varsity Healthcare Partners. "Similarly, investors, especially in this market, are looking for proprietary deal flow and low cost of investing."

## CEO expertise

Monte Brem, partner and CEO in the San Diego office of private equity consulting and money management firm StepStone Group, said he has seen situations in which the fundless sponsor is a CEO of a company that wants private equity capital to buy a competitor.

This type of fundless sponsor is a boon for private equity firm because he or she brings a lot of expertise to the deal. Those people have deep knowledge of specific industries or companies who shop transactions to private equity firms including the very largest firms, Mr. Brem said.

Many of the companies discovered by brokers are below private equity firms' radar screens because they are too small or in niche industries with which private equity firms are unfamiliar, said New Mexico PERA's Mr. Grabel.

These fundless-sponsor-sourced deals are in a "less efficient market," where pricing and competition are lowerMr. Grabel said.

Said Mr. Shaw: "Any good deal is getting bid up because there is so much capital on the sidelines."

There was a record $1.16 trillion of committed capital worldwide waiting to be invested in private equity deals as of June 30, according to Preqin.

Many fundless sponsors are adept at coaxing business owners in an industry they know to sell.

“Personal relationships go a long way,” Mr. Shaw said. “There's a lot involved that goes beyond the price the seller is getting.”

Mr. Lawson echoed this sentiment. For the most part, the way to get deals is to build a strong, more personal relationship with the business owner, he said.

Some of the best deals come from knowing business owners. An owner may be considering a sale but unsure of timing or may be unwilling to sell off 100% of his or her company, Mr. Lawson said. Those types of investments can reap handsome returns because there isn't a gang of bidders.

The hard part is finding a company that's not up for sale, Mr. Lawson said.

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