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'Fundless Sponsors': Separating the Good from the Very, Very Bad

By: Chris Nielsen

The concept of a "fundless sponsor" started in the 80's. Recognizing that this name might carry a negative connotation, it was changed to "independent sponsor" — a more palatable moniker. In a similar vein to independent sponsors is a "search fund," but for the purposes of this article, we will lump them together.

They are both a "fund with no money." They have no capital. The individual or capital group operating the fund may say they have "committed capital," but the commitment is only as good as the person/group making it or their interest in the investment you propose. Fundless sponsors and the operators of search funds may have "drawdowns" or "capital calls," but unless the cash is in your possession, I consider you to be fundless. Possession, as is said, is nine-tenths of the law. If its cash, its ten-tenths.

Compare a fundless sponsor to a traditional private equity fund, which is usually close-ended and has raised an allotment of money to deploy into investments. Such a fund is fully capitalized. Though the operators of a private equity fund may still finance a portion of an acquisition, they maintain an ample bank roll that makes the borrowing process smoother if they choose to go that direction for individual deals.

Brief History of Fundless Funds

For quite a few decades, little was known or heard about moneyless funds. They were run by astute business and/or finance individuals with ample monetary connections to follow through on purchase commitments. They funded their funds using some of their own money. They gained side-by-side investors by their reputations, and their reputations were good.

That all changed after the 2008 financial crisis. The little-known back channel of moneyless funds were a convenient alternative as the Dodd-Frank Wall Street Reform and Consumer Protection Act tightened regulations on how financial intermediaries operated, especially private equity firms. The Volker Rule, part of the Dodd-Frank Act, further increased regulations, forcing banks to look for alternative investment models, such as fundless sponsors. There was a bit of a loophole within the law that permitted banks to finance already-sourced deals in a fund, but banks could not "blindly" invest in close- or open-ended private equity funds.

There are a lot of advantages to the fundless sponsor model beyond avoiding regulations. It is flexible. Investors can pick and choose what opportunities they want to be a part of, such as industries they prefer or have experience working in, which allows them to provide stronger support post transaction. The investment period is typically shorter and avoids tying up capital for longer than you are comfortable. Long-term commitments can lead to underperforming investments where investors continue to get dinged for fees in a group of investments that has no exit opportunity due to the lack of performance (e.g., "zombie funds").

As investors took greater notice of fundless sponsors, the model naturally grew. There are now over 1,000 firms acting as independent sponsors. When these funds gained more attention following the financial crisis, a lot of them were, as previously stated, investing their own money and enticing other investors to join them. The practice was working, for the most part.

But for all the advantages, there were plenty of disadvantages. The lack of regulation, flexible models, and, most importantly, the fact that you technically didn't need a dime to start a fundless fund slowly brought less-than-qualified individuals to the table. The industry experts and well-connected, sound financial minds that were once leading these funds and bidding on well-scrutinized investments for their possible investors while taking into account their own business background have found themselves in recent years bidding against fund operators that could essentially have a name like "Two Guys with a Laptop and Associate Degrees in Finance Investments."

Our Experience with Fundless Sponsors

As a merger and acquisition advisory firm, we experienced frustration with the well-meaning and well-structured independent sponsor model. In the past five years or so, there has been a steady increase in these moneyless diploma holders who have wasted our time, our money, and sometimes our clients' money as they put in letters of intent and inundate us with information requests while they simultaneously shop the deal to anyone who will take a meeting. Once we identified the problem, and took a couple of black eyes, we knew we needed to avoid "Two Guys with a Laptop Investments" like the plague.

By the way, there are also those investors that could go by the name of "Older Guy Who Got Canned from a Respectable Private Equity Firm for Something Unscrupulous and Claims to Know Lots of Money People Investments." Avoiding either of these types of investors isn't difficult to do with a few simple questions we have learned to ask. Once we know who we are speaking with, my typical response to their queries goes something like this: "No thanks, we would only like to sell this deal once. Not once to you, 10 more times to your many 'investors,' and, inevitably, a twelfth time when the whole deal falls apart and we have to go back to market because a) You were recognized by your investors as fools who have no business operating a Jamba Juice, much less a $50 million durable medical equipment company and/or b) You outbid our other buyers and no one will finance the investment based on the multiple you are proposing." In most instances, the reason is the former.

The questions to ask that will help you identify a fund with no money and no chance of getting it are:

· What types of investors do you work with and which do you intend to approach?
· What are your personal relationships at those investors?
· What is your track record of financing and exiting deals?
· What operating value will you add to the company?

Vet these answers until you're satisfied or realize it's time to walk away. A simpler approach might be to add the following statement to the end of your non-disclosure agreement as you begin to market an opportunity:

Unfunded Sponsors: Percentage-based earnest deposits and proof of funds are required before any binding or non-binding letter of intent, offer to purchase, or anything that could be construed as such (offers) will be considered from unfunded private equity groups, i.e., independent sponsors, search funds, fundless sponsors. [Insert your firm name here] *will not accept offers from such groups at our discretion unless these conditions are met.*

Bottom Line

Stay vigilant, as stated in the beginning of this article, there are good independent sponsors out there with great minds and fine track records. But these others, who are becoming more prevalent by the day, are having a terrible effect on our business, well-intended independent sponsors, and all of our clients. Something should be done to curtail this trend, likely some form of regulation. Until that happens, always do your due diligence and only commit to those firms that can commit to your business.

About the Author

Chris Nielsen, Vertess Healthcare M&A Advisory Firm

Chris Nielsen is an experienced advisor and entrepreneur in the durable medical equipment (DME) and home health marketplace. Chris started his career as a securities broker and investment advisor before focusing solely on sell-side and buy-side transactional work in the healthcare space. As Managing Partner of Four Capital, he helped numerous clients successfully maximize the value of their company over the past 20 years**.**

Chris can be reached by email at: cnielsen@vertess.com

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