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Alternatives to Typical Private Equity Funds: Search Funds and Fundless Sponsors

Article By:

McDermott Will & Emery

We are frequently asked about the differences between a traditional private equity fund, a search fund and a fundless sponsor.

Many investors are familiar with the traditional private equity model in which a fund raises a pool of committed private capital, which it has a right to call for future acquisitions. That capital is then invested over a five- to seven-year horizon in multiple portfolio companies. The goal of these traditional private equity funds is to return the capital to their investors with a significant return on investment. In the traditional private equity scenario, limited partners are not allowed to pick and choose between portfolio investments, although there may be some opportunities for limited partners to make additional deal-by-deal co-investments. Typically, private equity principals take on an advisory, non-operational role with their portfolio companies.

Search funds are specialized "micro" private equity funds that are formed generally by one or two individuals for the specific purpose of acquiring one target company that the principals of the search fund then operate. Search fund principals initially raise "search capital" of approximately $500,000 that allows them a period of time – typically 18-24 months – in which to search for an acquisition target. At the time the Search fund is ready to purchase a target company, it returns to its initial search-stage investors (and also to other equity investors) seeking the required equity contribution to complete the acquisition. Search funds usually seek lower-middle market acquisition targets that fall below the radar of traditional private equity funds. Search fund principals take on high-level day-to-day management positions within the acquired portfolio company, effectively running the business from and after the closing. Search fund principals receive a salary from the portfolio company and also earn a carried interest on the equity investment that financed the acquisition.

Another variation on the private equity investment vehicle is a fundless sponsor. As its name suggests, a fundless sponsor is a private equity professional or group that searches for acquisition targets first, then shops those acquisition targets to known sources of equity capital. Many traditional private equity funds are willing to invest in transactions that are shown to them by fundless sponsors. However, because private equity sponsors will often attempt to negotiate an economic split that is less favorable to the fundless sponsor, fundless sponsors many times aim to find sufficient sources of equity capital to prevent any one source from having significant negotiating leverage. Fundless sponsors will sometimes maintain a role with the target company after the acquisition is consummated, often in the form of a board seat, but are usually not involved in the day-to-day operations to the same extent as search fund principals.

Private equity comes in many different forms and sizes, and with the growth of private capital, search funds and fundless sponsors are becoming more commonplace in the middle market today.

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