The Five Tools of Private Equity – Introduction & Part One: Sourcing

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Successful investing requires a constellation of abilities, not all of which are of equal importance.

Mike Trout is today's quintessential five-tool baseball player. He can play defense, hit for average, hit for power, has a cannon for an arm, and his speed on the basepaths changes games. All five of the "tools" have been described by baseball scouts for a century; a "five-tool player" being shorthand for an exceptionally well-rounded player, able to excel in each facet of a game that demands very different capabilities in different phases.

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Seattleites of a generation ago would have described Ken Griffey Jr. the same way; further back still, we may have been discussing the merits of Mickey Mantle or Willie Mays. Although times have changed, the point has not: a well-rounded player has superlative value, and the domains of ability are independent.

If you'll permit the metaphor, private equity investing is like baseball. Sort of. For an investor, the life cycle of a single investment requires excellence across a number of domains that are, at best, loosely related.

Just as a baseball player's ability to steal bases and his ability to slug home runs are independent, there's not much overlap in an investor's ability to originate actionable investments and that same investor's knowledge of the tax impacts of a particular transaction structure. It stands to reason that a "five-tool" investor would be well-positioned to earn outsized returns on its invested capital; but, same as there are slow, hulking sluggers in the Baseball Hall of Fame, some investors have made a career out of focusing on one or two dimensions of excellence and doing just well enough across the others.

In this first part of a multi-part series, we'll walk through the different capabilities required for an investor to succeed, and how those elements take shape in today's professional investors—with an eye toward unbundling their respective contributions to an investor's value creation. We'll find that not every tool is equal in its contribution to success.

The five tools:

1. Sourcing
2. Evaluating
3. Transaction Execution
4. Portfolio Management
5. Fundraising & Financing

Sourcing: Developing Investments

Investors need investments, and there are a few ways to develop "deal flow." While the true spectrum of investment development is more nuanced, an easy way to segment the strategies is to split them into two camps: "intermediary" sourcing and "proprietary" sourcing. Intermediary sourcing is as it sounds: dependent on intermediaries (investment bankers or brokers) reaching out to investors on behalf of owners ready to transact. Proprietary sourcing can be thought of as "everything else," as it represents any sourcing strategy that doesn't involve an intermediary.

Intermediary sourcing requires deep "rolodex development" on the part of the investor, as staying top of mind across dozens (or hundreds) of intermediaries as an actionable buyer of a business is challenging. As the number of active investors (strategic buyers, private equity firms, independent sponsors, and search funds, to name a few) has rapidly proliferated, the ability of an investor to differentiate itself from others has become markedly more difficult. Most investors in the middle-market pursuing an intermediary-focused sourcing strategy can best hope to be included in an investment banker's buyer database to receive teasers, along with a few hundred comparable firms with similar size and industry investment criteria. A middle-market or larger private equity firm often has dedicated business development professionals, while smaller firms will include sourcing as a responsibility of investment staff (usually delegated to mid-level investment professionals or below).

Proprietary sourcing is the converse: the investor directly reaches out to business owners. Depending on the investor's strategy, this can take a lot of different forms. For an investor who is generally agnostic to industry and is just looking for willing sellers, this becomes a high-volume numbers game, and in this day and age they likely employ automated tools (web scrapers, contact database sorting, and automated email construction) along with inexpensive help (unpaid university interns, low-wage overseas virtual assistants) to make enormous volumes of phone calls and emails to business owners. Some investors employing this strategy will even pay a finder's fee: up to 1-2% of the size of the closed transaction as an incentive for third parties to funnel possible investments their way. For an investor who has spent time and effort to develop a very specific investment thesis, outreach looks much more targeted, as this investor might only reach out to ten or twelve companies and continue developing relationships with those companies over many years.

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One might notice that despite the advent of third-party tools and strategies to increase an investor's reach into a marketplace, the sourcing function cannot be completely outsourced. The outsourcing of sourcing (and even the business development function, if internalized) can be thought of as creating introductions. Introductions are valuable—a deal can't be closed without it starting as an introduction—but an introduction fails to convert into an actionable opportunity without a decision-maker involved. That almost always falls to a partner or principal to create a relationship with the seller and curate a deal that can be evaluated. As such, there is a disconnect between the relative value of the sourcing function (very high) and the price of third party sourcing or finding (not as high), because the third party can really only generate leads and not live deals.

Sourcing, of all five of the “tools,” is one of the two non-negotiable abilities—without a willing seller, the rest of the tools are immaterial. There are many different ways to develop actionable investment opportunities, and investors can staff (or outsource) in multiple unique models to supplement those efforts. Different strategies have come in and out of popularity over the last 40 years of modern private equity, but they all have been and continue to be successful if employed in alignment with the investor's strategy and team capabilities.

Once an actionable investment is at hand, the next step is to evaluate its merits. Next time – a deep dive into evaluating investment opportunities.

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