ACCRETIVE USES 'TAKE PRIVATE' TACTIC IN EQUITIES

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By Herbert Lash

NEW YORK, Aug 23 (Reuters) - Like most money managers, Rick Fearon thought outsized returns would be more than enough to grow his $20 million fund.

But Fearon, founder of hedge fund Accretive Capital Partners LLC, faces what industry experts say is an almost impossible task as he tries to grow by raising $250 million -- more than 10 times his existing asset base.

Although he has managed to boost returns almost fourfold since he started in March 2000, that record generally isn't enough to attract big institutional accounts, the experts say.

It took Fearon, 44, a long time to understand that his existing investors could benefit from a larger Accretive Capital, which he runs from behind the town library in Madison, Connecticut.

"It was almost the 'Field of Dreams' philosophy that if you build it, they will come," he said. "I felt that keeping expenses low and focusing on generating returns for my existing investors was what it was all about."

Accretive Capital's strategy is to buy long-only stakes in small- and micro-cap stocks that Fearon believes would be attractive "take private" companies. The benefits of being public just don't add up for such companies, he said.

Years ago when Fearon was a principal at private equity firm Allied Capital, he was struck by the wide gap in value the public and private equity markets assigned companies.

In private equity, companies were valued at six to seven times their cash flow, while public companies, especially the smallest businesses, were valued at almost half that, he said.

Fearon believes that market inefficiency, where prices often fail to reflect a company's intrinsic value, and the $400 billion or so that pension funds and endowments currently have committed to private equity, will help spur returns.

Fearon is fishing in waters where, because the market capitalization of the smallest companies is less than $100 million, Wall Street research fails to adequately cover their operations. In addition to helping create an inefficient market, it has eroded the benefits of being a public company.

With an undervalued stock, stock options are never in the money, erasing the use of stock as a motivator for management and employees; cash becomes preferable to stock for acquisitions, and management holds on to undervalued shares.

"Management teams that have a strategy of A, B, C and D for creating shareholder value may in the back of their minds be thinking, 'Well, maybe strategy E is the take private transaction, or we sell the company to a strategic buyer, because we're not recognizing any of the benefits of being public,'" Fearon said.

Accretive Capital has been involved in 19 take-private transactions, or about one-third of the positions it has closed over the past decade.

Fearon has managed to take the $2 million in capital he started with from mostly high-net worth friends and family to about $20 million on his own. His fund plunged in 2008, but returned 132 percent last year and is up about 20 percent as of July.

Fearon has hired as principal a person who has worked part-time for Accretive the past six months, and he expects to soon take on a former analyst from hedge fund Ivy Asset Management, who also has a legal background.

In many respects, managing money is the easy part.

Investors want many things -- pedigree, track record, investment process, and team and operational infrastructure -- before they will commit to a small hedge fund, said Jack McDonald, chief executive of Conifer Group, a prime brokerage that serves start-ups and funds with up to $2 billion.

But the biggest difficulty is gaining sufficient funds. Many investors are reluctant to invest in a small fund as a $20 million stake could be half a fund.

"It's really hard to get a business off the ground with a sub-critical mass of assets," McDonald said. But once initial asset hurdles are met, new investors will more readily follow.

Fearon agreed: "We're not lacking investment ideas or opportunities, our primary restraint is capital right now."

Of the almost two dozen investors in Accretive, not one has pulled out and Fearon has never taken a distribution. His salary remains fixed at $100,000; when returns dropped almost 29 percent in 2002, he did not take a salary that year. At Allied his compensation had reached seven figures.

"We share a common set of values," Fearon said of his investors. "We believe that the business of investing capital can also be a noble business -- the same way that I look at the medical profession as an endeavor that is worthy." (Editing by Leslie Adler)