

SEARCH FUNDS – WHAT HAS MADE THEM WORK?

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Introduction

The purpose of this note is to highlight the key success factors of search funds, an entrepreneurial acquisition model that has been successful in the United States and Canada for over 30 years.

The note presupposes a knowledge of search funds on the part of the reader, though a brief summary is also provided in the next section. To benefit most from this note, prospective searchers and search fund investors should first be familiar with the reports from Stanford Graduate School of Business and IESE Business School, available from those schools' websites: www.gsb.stanford.edu/ces/resources/searchfunds; www.iese.edu/en/faculty-research/research-centers/eic/search-funds.

This study is based entirely on interviews conducted in the summer of 2014 with 17 people who were involved in early search funds in the United States and the first one in the United Kingdom and who continue to be involved in more recent search funds. They include some of the first searchers as well as their investors, some of whom have now invested in over 100 search funds.

The text of the note is predominantly the words of those people, with minimal additions by me, although I have added clarifying language where needed. I want to recognize those individuals and thank them for taking the time to speak candidly about their experiences with search funds. Their names are listed at the end of this note.

What Is a Funded Search?

A funded search is an established process whereby a young and talented entrepreneur (or a pair of entrepreneurs) with little or no CEO experience secures funding (the “search fund”¹) from a group of investors (mostly individuals) to pay for a nominal salary and expenses for a period of

¹ The terms “funded search” and “search fund” are often used interchangeably, although technically a search fund is the initial small fund that is raised.

two or more years while the searcher looks for a company to buy. Searchers are typically, though not exclusively, recent graduates of MBA programs. Search funds typically range from \$/€/€300,000 to \$/€/€500,000, funded usually by 12-18 investors (typically \$/€/€25,000 to \$/€/€35,000 per investment unit).

During the search phase, the searcher usually works most closely with two or three of the investors, who provide general guidance, due diligence assistance and deal structuring advice. (In the United States and Canada this guidance is usually done on an informal basis, whereas in Europe the tradition is to form a Board of Directors for the search fund during the search phase.)

Once a target company is identified and a deal is negotiated with the seller(s), the searcher presents the deal to the search fund investors, who have the right of first refusal to invest in the acquisition. Everyone's search fund investment, including that of any investor who chooses not to invest further in the acquisition, rolls into the deal, usually at a stepped-up value (typically 150%).

The searcher then becomes CEO of the acquired company and receives ownership in the company (typically 20%-30%), with one-third owned following completion of the deal, one-third earned over a period of four to five years of service, and one-third based on achieving the target IRR for investors (typically 30%-35%).

Upon completion of the acquisition, two or three of the search fund investors join the Board of the newly acquired company, providing guidance to the new CEO and ensuring proper governance of the company.

Going back to the first search fund raised in 1983, there have now been nearly 200 funded searches in the United States and Canada. The aggregate pre-tax IRR on the 134 funded searches tracked and analyzed by Stanford Graduate School of Business in its most recent study is 34.9%.² Only recently have there been a number of searches completed outside the United States and Canada – the first such search fund was raised in 1992 in the United Kingdom – so there are insufficient return data to draw any conclusions about searches outside the United States and Canada.³

The remainder of this note (including references to statistics) consists of the words of the interviewees. Individuals' comments are aggregated by topic, so you will hear multiple voices in each paragraph and sometimes in a single sentence.

The Search Fund Model

A search fund is focused singularly on acquiring one business and then growing that business. A fund investing in more than one company is an investment fund, not a search fund.

The logic for the model is fundamentally indisputable. For investors, it is a chance to invest in high-caliber talent early in their career, targeting the least efficient segment of the private equity market (the micro-growth market), with the ability to mitigate the risk of an inexperienced CEO with the experience of the investors. For searchers, it allows an early-career

² See *Search Funds – 2013: Selected Observations*, Stanford Graduate School of Business, E-521, June 2014.

³ See *International Search Funds – 2013: Selected Observations*, IESE Business School, ST-342-E, June 2014.

entrepreneur to become a CEO with a significant equity stake without prior top management experience.

The search fund model addresses a fragmented and inefficient part of the market – deals too small for institutional investors and too large for most groups of angels. Search funds benefit from the fact that companies with EBITDA below \$5 million are not attractive to the rest of the world; yet once an entrepreneur builds the company to EBITDA above \$5 million, the rest of the world wants it and is often willing to pay a high price for it.

The value proposition of a search fund to a seller is material. Entrepreneurs like selling to a younger version of themselves, and they often choose this option over private equity or strategic buyers who may be offering higher prices. This doesn't mean that search funds are buying cheaply, but it is an advantage that enables a search fund to buy a company that otherwise might be too expensive. It is also an organic succession model for entrepreneur-owned businesses, which can lead to attractive acquisition options for search funds.

For the searcher, a funded search develops the person in a career rather than in a job. He or she gets an education in how to assess deals, how to negotiate a deal, how to raise bank debt, how to deal with things going wrong and managing through them. He or she finishes as a well-rounded businessperson. For the entrepreneur, the search process is a good testing ground and serves the entrepreneur well if it prevents him or her from buying a bad business. Even in a search that fails to find a company, the searcher usually lands on his or her feet.

The search fund model is based on a three-legged stool:

1. Jockey – the entrepreneur – bright, talented, but inexperienced as a CEO;
2. Trainer – the investor with operational and search fund investing experience – providing oversight and guidance to the searcher and inexperienced CEO (training the jockey rather than the horse); and
3. Horse – the company (and its industry).

The importance of this analogy is discussed further later in the note.

Collaboration is fundamental to the model: collaboration between the entrepreneur and the investors, collaboration among the investors, and collaboration among the wider search community. It is fundamentally a collaborative ecosystem. The model aligns incentives more so than in any other ecosystem: if investors do well, so does the entrepreneur.

There is something symbiotic about the model that traditionally has brought together more empathetic investors with grounded and idealistic entrepreneurs. The model has proven to be very collaborative – everyone usually seems to be on the same page.

The model works – as evidenced by the returns from the entire universe of searches – even though 25% of searchers fail to find a company and one-third of operating companies do not return capital.⁴ The model has been jiggered over time, but the fundamentals remain valid – they have passed the test of time. Variations on the model that are not able to capitalize on the collaborative ecosystem are not likely to work as well.

⁴ See *Search Funds – 2013: Selected Observations*, Stanford Graduate School of Business, E-521, June 2014.

Search funds are a great asset class. They have different risk profiles and different returns from private equity and venture capital. They capitalize on a micro-buyout approach without excess leverage. A funded search is a form of growth equity at a good acquisition price. From the investor's point of view, the try-before-you-buy element is also attractive.

European search funds are currently benefitting from some of the factors that made early U.S. search funds successful (see below). Still, some cultures are better suited for search funds because (i) they do not have such a strong tradition of handing down businesses in the family and (ii) in such countries there is less perceived risk in backing a young, less-experienced person.

The Searcher – the Jockey

Searchers are drawn to the search fund model because they feel this route allows them to chart their own course and be independent. They are willing to step off the fast track and initially take a step back in order to do what they want to do.

Searchers must be clear about the reason for doing a search. They must want to run and build a business, first and foremost. They must have a real passion for running and building a business rather than seeing this as a stepping-stone to something else, such as private equity investing. That, in turn, means that they must be focused on finding a business that makes sense in every way.

There is an irony in that the most important decision is what the searcher ultimately buys; but the best searchers are primarily engaged in the business itself, in running and building it – not so much in doing the original acquisition. Thus, the investor is really backing the person to be a manager, not necessarily because he or she is a gifted dealmaker.

It is important for searchers to know and fully understand what they are getting themselves into. Running a company and owning a significant share sounds great. The reality is that the search phase is hard and lonely; ensuring a good fit between a company and the searcher is hard; and there are lots of NOs along the way. Before starting, a searcher should do the research and talk with other searchers – those who have acquired a company, those who failed to find a company, and those who are currently searching.

It is difficult for investors to pick the “right” entrepreneur up front, although they can certainly weed out the negatives. For the search phase, one wants to see an entrepreneur who has the courage to make lots of cold calls and be rejected a lot, is willing to get on a plane and meet with lots of sellers, and is able to form a relationship with a seller.

Investors will assess the searcher's search strategy, industry choices, company screening criteria, and planned search process. Then the investor will assess the subjective traits. Important traits include intellectual horsepower, disciplined and rational thinker, problem-solver, prepared (vs. casual), good selling skills, good communicator, resourceful, entrepreneurial, demonstrated past success, shows willingness to listen, open and transparent, humble.

Search fund investors want to back someone (a) who is hungry, talented and focused and (b) who listens (and asks questions) and shows some humility. It helps if they have done more work on search funds – a survey or in-depth search project or working as an intern for a searcher. It is even better if they have done enough work to uncover a new industry segment

(new for search funds). They should be able to have a substantive dialog about their selected industry sectors.

Search partnerships are helpful, as having a second view on all decisions can lead to better decisions. There are risks that the partnership may not work, but the benefits outweigh the risks. A single searcher should consider hiring a senior person who can play the partner role with them. Having said that, the statistics show that while two-person searches do indeed have a lower probability of a bad outcome (not finding a company or buying a company that does not work out), there is no distinction regarding large winners.

There is no evidence of criteria that will screen searchers who are more likely to find a company. The way an investor ultimately makes a judgment about searchers is to see how they think about deals and how they process them along the way – that helps the investor determine whether he or she will ultimately invest in an acquisition.

The Search Fund Investor – the Trainer

Money has faces. It is important who your investors are.

The quality of the investor group makes a big difference. It is very important to have a good group of investors because they will play an important advisory role during the search and while running the business. Investors who are actively supportive are key. In the early part of the process (two years of searching and the first two years operating), searchers are more reliant on investor guidance. Later that flips, and the entrepreneur becomes the complete CEO. Investor experience plays a big role in filtering deals and then on the Board. Thus it is key to attract investors who have the experience and the time to help the entrepreneur. From the investor's perspective, this is almost more important than the selection of the searcher.

The analogy of investors as trainers is key. They are the ones who will guide the searcher during the search and “train” the new CEO after the acquisition. This is why operational experience and experience with the search fund model are so critical among the investor group (and on the Board).

Good investors have kept searchers from doing bad deals. Experienced search fund investors will recognize the difference between a “good deal” and a deal that is a good fit for a particular searcher. In this regard, which individuals the entrepreneur is listening to from the investor group is important. One wants a collegial group of investors, people who know and trust one another and can pick up the phone and talk through issues with one another as well as with the searcher. It helps when investors have co-invested with people they have worked with for many years because they know how those investors will react to issues, problems, and opportunities. That becomes a risk when the investor group includes many new investors.

There are not that many investors who understand the search fund model, and those people have limited time availability. It is key to ensure that some of them will devote time to a specific search fund. Also, the growth in the number of searchers is outstripping the number of experienced search fund investors, so it is critical to secure commitments from a few experienced investors to spend the time to help in a given search.

It is important for the searcher to have good mentors. Not many people understand what the entrepreneur is going through in this process, so the investor needs to be empathetic and

supportive. An empathetic investor will understand that the entrepreneur has made a very hard career choice and will try to provide moral support. Having said that, there is a fine line between being a mentor and being a third-party investor.

The most important thing is to have a range of operating experience among the investor group. It helps to have advisers from among the investor group who have relevant operating experience; then the searcher has to be willing and able to listen and learn from them. The key from the searcher's perspective is to surround oneself with experienced search fund investors and listen to them. A good company with a good investor group and a good Board equals a good deal for the searcher and the investors.

The searcher must be confident while also recognizing that he or she doesn't know everything. It is important to be open to the advice and wisdom of experienced investors and not let youthful exuberance lead to bad decisions. The searcher should treat the investors as partners. It is important to foster open, honest exchange with the searcher and have frank and honest discussions about money matters (earned equity, etc.).

Clearly an investor has to bring more than cash to the search fund. Money alone is not added value; one needs to be able to give good advice, with patience. Searchers should not seek passive investors, although not all investors will be actively engaged in each search – they will share the responsibilities across different search funds. New investors to the model can also be mentored by experienced search fund investors. They should not be interfering and badgering; rather, they should be collaborative and long-term oriented and have the patience to work with and advise an inexperienced searcher and CEO.

The bandwidth and experience of the investor group may not be enough in a particular deal, so the searcher may need to find outside help (an adviser or director). He or she may need specialty, deep-domain expertise to assess a company and/or to serve on the Board. This can be a bottleneck, so it is important to address it when raising the fund – determine which investors have the right experience and will devote time to your deal.

While the great majority of serial search fund investors are based in the United States, U.S. investors want to see several local investors in overseas search funds, especially those with search fund experience. Local investors will pick up on things that U.S. investors may not be familiar with in that country.

The Business – the Horse

The horse is more important than the jockey. It is absolutely critical to buy a good business.

The most important decision is what to buy; so understanding what makes a good business is critical for a searcher. A good business can carry an average manager; however, with a bad business, even a great manager cannot succeed.⁵ Remember that there is a 75% chance that a searcher will buy a company, so buying the right company is critical.

⁵ Several people referred to Warren Buffett's famous quote: "When a manager with a reputation for brilliance takes on a business with a reputation for bad economics, it's the reputation of the business that remains intact."

The search fund model has been based on a proven set of criteria for finding a company. There is great power in a core set of criteria:

1. Growing market;
2. Company history of growth and profitability;
3. Major component of recurring or repeat revenue; and
4. Low CAPEX requirement.

Finding a company in a sector that is growing fast is key. It is extraordinarily important to have a wind at your back. It is also important to be in a fragmented industry where geographical presence makes a difference and a larger company operating nationally doesn't have a particular advantage.

Once the searcher has identified a really good industry sector, one that is growing, the challenge is to find a robust company that also has some downside protection. Predictable revenue (recurring and/or repeat revenue) provides great value to the new CEO. A business with recurring revenue is more resilient and resistant to mistakes, thus allowing management to allocate more time to value-added projects rather than to firefighting. At the same time, statistics show that while recurring revenue protects the downside, it does not necessarily boost the upside in a company.

Cash generation resulting from low CAPEX provides a good margin of safety. Businesses with low CAPEX also tend to be less complex managerially, which is better for an inexperienced CEO.

Eighty percent of early funded search successes had all of the above key characteristics. The searcher must be disciplined about focusing on these criteria. Other important factors to consider include high barriers to entry (often evidenced by pricing power) and simplicity of operations. Searchers are cautioned to be wary of highly regulated industries, customer concentration, cyclical businesses, and situations where the owner has close relationships with key customers. Turnarounds and roll-ups should be ruled out.

Yet while these criteria are sound, there aren't a lot of small companies that fit the recurring revenue / simple business model. Thus it is important not to dismiss industries that look very complicated at first – you only really see the opportunities once you get inside the industry, know the players, and begin to understand a sector.

Many deals involve companies that were built by an entrepreneur, using little capital, into growing lifestyle businesses. Many of these companies are unsophisticated – they were built without the most up-to-date processes and technical systems. The companies might also have been drained of cash via dividends, with minimal reinvestment. Adding a smart CEO and new capital can help improve these shortcomings, which is part of the rationale for a search fund deal.

At the same time, the search fund acquisition may end up loading the company with debt and a substantial amount of equity that requires a very high return. This ultimately changes the company into a different business and can make it much harder for the numbers to work for the searcher. This can result in searchers' not earning their performance equity.

Deals that deviate from the core criteria have worked, some with very good returns. This has led some investors to support deals that deviate from the traditional criteria; however, the overall success rate of such deals is lower. With a portfolio, an investor can afford to consider more outliers as long as the deals are priced properly. Yet this can be a riskier strategy for a searcher because he or she only has one deal. In such outlier deals the searcher must understand the challenges inherent in buying a company without those core characteristics.

Internationally, there is an interesting subset of searches showing success with greenfield start-ups based on models that work well in the United States. This represents an opportunity to create new businesses with the characteristics of successful search fund deals – layering the talented individual with no experience on a business idea with the right characteristics, which increases the likelihood of a good outcome.

The Search Process

A searcher must have a strong search process. Search strategies that have proven successful have included the following tactics:

- Focus on one or two industries at any given time.
- Know those industries very well so that you have credibility with sellers and can have meaningful discussions with sellers about their businesses.
- Have a travel budget large enough to visit lots of companies.
- Have a bias toward action – get out and see people!
- Talk with everyone you can in the industry.
- Develop a relationship with the seller.
- Don't rely too much on brokers; focus on proprietary deals.

It is important to search in an efficient way by ruling out inappropriate industries or companies and focusing on the key criteria. This leads one to service businesses that are simple to operate, not manufacturing; to tech-enabled companies, not tech-centered ones; to product improvements, not product development; to a growing market, not dependence on taking market share from someone else. There are real benefits to industry focus; random, opportunistic searches usually don't work. A pair can do both an industry-focused and an opportunistic search, but a solo searcher should remain industry-focused.

The searcher needs a process that will yield maximum results. It is a mining process, a real volume job. The searcher has to figure out a way to maximize the number of deals he or she looks at in order to find the good ones. It is not simply a matter of calling all the people you know – that is not enough.

It is also not a one-person job, which is why single searchers use interns, “river guides” and outsourced services. It is not a good use of the searcher's time to be identifying 200 companies in an industry and finding their e-mail addresses – this is something that can be outsourced. Managing interns can also be a useful way to get experience in managing and motivating people.

The searcher must be clear on the search criteria and be disciplined about them and willing to say no early on. It is a cumulative process – difficult at first, but as the search progresses the searcher becomes more knowledgeable and the process gets easier. Persistence is probably the most important quality – the ability to stick to it through all the ups and downs of the search (as well as afterward in managing the company).

Seeing criteria written on paper is different from really understanding what they mean and how to assess a business. This is a transition that the searcher has to make quickly during the search phase. The searcher needs to internalize the business criteria, not just memorize them – he or she must be able to explain how and why a company meets the criteria (or doesn't). Otherwise, the searcher will just waste much search time on deals that won't close. Time is the searcher's enemy, so it is critical to focus on deals that can work and that investors will back.

The first four months of the search are critical because it is then that the searcher either achieves real progress or gets bogged down in false activity. It is a numbers game, and the searcher should be talking to two or three CEOs every day. Yet activity is not the same as progress. While there may be a correlation between the number of deals seen and success in making an acquisition, this factor is overridden by the importance of the core company criteria – quality is more important than quantity. It is best to focus on an industry, learn it and get to know it deeply, build a network in it. Then the searcher may find opportunities that he or she didn't even know existed in that industry.

Progress is represented by proprietary deals: getting in front of sellers and forming a relationship with them, thus making it possible to buy a company at a reasonable price. It is important to focus on proprietary deal sourcing – go to trade shows, get to know the key people in the industry, learn how they think and talk about the industry.

The search process is highly emotional in nature because there will be a binary outcome. It is a stressful time. The biggest risk comes when the searcher is running out of time; it is then when he or she may feel pressured and make bad decisions, leading to a questionable deal getting done. Thus, it is important to get signed letters of intent (LOIs) early in the search, even if it appears unlikely that the deal will close – don't wait for the perfect deal before moving forward. The experience of negotiating and signing an LOI and doing the due diligence shows the searcher what is possible, provides more knowledge about deal-making, and takes some of the time pressure off.

When a searcher wants to get investors' opinions on a deal, it is better to solicit two or three opinions before going out to the whole group. Don't send out a summary to all investors and ask, "What do you think?" That leads to group-think led by investors rather than the searcher's own decision. It is important for searchers to recognize that this is their asset – they really have to figure it all out. It is not up to the investors and should not be their call. Searchers should listen to investor input but make their own decisions. At the same time, it is important to be fearless about approaching experienced search fund investors when needed and then to listen to them. It is best for the searcher not to operate in "sell" mode; rather, explain the deal clearly and openly and then listen to the investors' reactions. Use their experience to get guidance on which deals to spend time on.

The Search Fund Structure

The search fund model has subtle hurdles that act as barriers. The biggest hurdle is raising the initial search fund because it can be so difficult to sell the concept. Once they have done that, searchers know that they can raise capital later for the acquisition.

The cap table matters. One wants a diversified investor group – not a single large, dominating shareholder. An entrepreneur with a diversified investor base and a large ownership stake in the company really does feel like he or she is running his or her own company, which is a tangible benefit of the model.

Having too many investment units is not good. It is better to have fewer committed investors, provided that those investors have the capacity to invest more in the acquisition. The searcher probably can raise the acquisition capital from eight investors. Ten to twelve investors in the search fund is probably ideal.

Money is not the issue at the search fund stage; intellectual help or “mindshare” is, so it is important to attract investors with the time and experience to help the entrepreneur. The number of investors who can be active in a particular deal is key. It is best if three-quarters of the investors have search fund experience.

It is important that both the searcher and the investor believe they have an attractive deal. It has to be viewed as a partnership. Arm wrestling over percentage ownership misses the point. What is important is to make it successful and focus on what can help achieve that.

Acquisition Financing

Leverage does make a difference. EBITDA growth plus financial leverage is what leads to good returns. Securing debt is also important in validating the robustness of the business. All-equity deals belong in the venture capital space, not in a search fund (although investors as well as the seller can be sources of subordinated debt).

Now companies are experiencing lower growth and the level of bank debt in deals is lower, which reduces the potential returns dramatically. Today’s search funds may not work as well as the early ones because it is more difficult to make the numbers work, which means that the proportion of searchers who fail to find a deal is likely to increase. For investors, this means investing in more search funds in order to increase the odds of success.

Where searchers do make acquisitions, it can be difficult to achieve the targeted returns, with the result that many searchers may not earn their performance equity. This is simply the nature of today’s marketplace. Changing any of those factors just a little – growth rate, level of bank debt and corresponding level of equity – makes a big difference to returns. This further underscores the need for the searcher to identify industry sectors with higher growth rates.

Board of Directors

Board composition is the differentiating factor in successful companies.

The Board of a search fund company (the acquired company) needs directors who understand how search funds work. The volume of search fund deals has outpaced the number of available Board candidates who are experienced in search fund deals, resulting in a need to cultivate more directors. Serving as a director on a search fund company Board is different; it is not hard, but it is unique because it involves a CEO who is inexperienced, learning on the job, and in need of guidance. Investors serving on Boards must understand how the model works and how to mentor the searcher.

Investors new to Boards of search fund companies need to leave at home their previous ways of thinking about business. Most people have never bought a successful company and then made it more successful, which is the challenge for this inexperienced new CEO, whose biggest need is guidance. A director should be patient and supportive, provide contacts, and be a thought partner with the CEO.

It matters to investors who the directors of the acquired company are. Serial search fund investors must share the workload across search fund deals. It helps when investors can rely on investor-directors they have worked with for many years because they know how those investors are likely to react to various issues.

It is important to get the right mix of experience on the Board: financial experience and operating experience are key. Operating experience is more important, especially experience running a business of a similar size in a growing market with some element of recurring revenue. Relevant industry experience is helpful but is less important and can be overvalued; industry expertise can also be bought from consultants. Large-company operational experience is even less valuable.

New CEOs have issues with pattern recognition and general experience. Good directors can help them prioritize their inbox and focus on the things that matter. Active, engaged directors will ask the right questions and redirect the entrepreneur when needed. They can prevent young people from making serious mistakes. A common mistake that new CEOs make is to focus too much internally, but the Board can redirect their focus and get them out talking to customers and selling.

Strategy is not so important for the first several years. The new CEO first has to learn the business and then has to learn how to sell and to optimize the current strategy. Only then, after one or two years of selling and understanding the customer, might he or she have learned something that could lead to a strategic change, and even then it may not result in a meaningful difference. Early searchers were able to learn their businesses without undue pressure; now the pace of change is so high that it is harder for an inexperienced CEO. That makes Board composition and director guidance even more important today.

A director has to be more alert to macro cycles because the entrepreneur will be totally immersed in running the company. In this regard, getting the timing of an exit right can affect returns dramatically.

Concluding Observations

Investing in a search fund is not a hardheaded decision; whether to invest in the acquisition is the key decision, and the investor's ability to decide on acquisition investments correctly is critical to achieving good overall returns. Investors with the best returns have been good at selecting which deals to invest in; the ones on which they have passed have, in aggregate, barely returned capital.

Remember that luck plays a big role, too; good fortune always helps.

While the horse may be more important than the jockey, good jockeys tend to end up with better horses.

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This note was made possible by the generous cooperation of and numerous insights from the following individuals:

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In keeping with the collaborative nature of the search fund model, they all know one another.