Case # 5-0034

TUCK SCHOOL OF BUSINESS AT DARTMOUTH
CENTER FOR PRIVATE EQUITY AND ENTREPRENEURSHIP

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Note on Search Funds

A search fund is an investment vehicle used by one or two individuals to finance the process of finding and acquiring a company. The initial investors in the search fund are guaranteed the right to invest at attractive terms in the acquisition financing round. To young MBAs seeking to own and manage a company early in their careers the search fund model offers a unique opportunity.

Since a majority of startup businesses that fail do so very early on, an aspiring entrepreneur who wants to avoid company formation risks can instead buy an existing business.[1] The search fund model was developed in 1984 at the Stanford Graduate School of Business. Since then many teams of young MBA graduates and experienced managers have been establishing search funds and acquiring companies successfully.

Raising a fund

The first issue to tackle regarding raising a fund is establishing a compelling investment proposition. Will the fund be geographically focused? Industry focused? How can the principals' backgrounds and experiences be best matched with target company characteristics?

[1] sba.gov

This case was written by Elnor Rozenrot T'06 under the supervision of Adjunct Associate Professor Fred Wainwright of the Tuck School of Business at Dartmouth College. It was written as a basis for class discussion and not to illustrate effective or ineffective management practices.

Selecting and using the right advisors is important in generating credibility for the fund (especially if the principals are young MBAs). Advisors are also important during the followup stages of seeking, acquiring and managing the target company. Potential advisors can be previous search fund principals, business school professors, key investors in the search fund, industry leaders, or individuals with functional expertise. Good advisors can provide[2]:

- A sounding board for ideas
- Industry contacts to help generate a deal flow
- Access to networks for fundraising, industry expertise or other advice
- Leverage with lawyers, accountants and bankers

The fund principals prepare a formal proposal (investment memorandum) to present to potential investors. Legal advice is essential to adhere to relevant state and federal securities laws.

For investors, a search fund represents an attractive investment for several reasons:

- *Above average returns* – A 2003 study conducted at Stanford found that first-time search funds produced pre-tax annualized returns of 32%.
- *Limited initial investment* – The search fund is a staged investment. The purchase of a unit in a search fund does not create a commitment to contribute additional capital in the acquired company. The investor has the opportunity to become more familiar with the principals during the search process and to analyze the investment opportunity provided in the second round with significantly more information. Initial investors often gain preferential rights to the acquisition round. The option value of the initial investment, therefore, creates an opportunity.
- *Personal interest* – Some search fund investors describe being partly motivated by the interest of helping a young team succeed. Of course, the financial aspect of the deal needs to be appealing, but this additional motivation can forge a strong bond among investors and fund principals.

Conversely, the unattractive characteristics of a search fund opportunity are:

- *Inexperienced principals* – Many principals have little or no experience in acquiring companies so there is a danger of exhausting the search capital without finding a suitable acquisition target.
- *Limited operating experience* – Assuming success of an acquisition, the search funders have to manage a company. Some of the principals will be less experienced with the operations of a company.
- *Limited market for private equity shares* – If the target company does not perform well after the acquisition the investors may have difficulty in monetizing their investment.

[2] Early Career LBOs Using The Search Fund Model

The amount of capital to be raised varies from fund to fund and is basically intended to provide one or two principals with salaries for approximately two search years with an additional budget for expenses such as travel, office, legal, and due diligence. Depending on the required amount, a group of 8-20 investors is typically needed. There are pros and cons of having less or more investors. Issues to consider include control agreements among the investors and principals and the capacity of the investor base to contribute additional capital to the acquisition phase.

Those investors who participate in the initial round of equity financing will buy investment units in the fund and receive:

- *Pro-rata right of first refusal to invest additional capital in the acquisition.* Investors will have the right but not the obligation to participate further in financing the acquisition.
- *A 'stepped-up' interest in the acquisition for the target company.* Investors who take the risk of investing in the initial round of financing usually receive a carried interest in the acquired company equal to their pro rata share of distributed search funds plus a step-up in value. This premium will be awarded regardless of the investors' participation in the target acquisition round.

As with advisors, search funders try to achieve a good mix of investors with different skills and interests such as operations experience, industry expertise, or even moral support. Often times, one or two experienced investors can serve as "anchor tenants", since some passive investors prefer to follow others' commitments. A few larger investors can simplify the selling and negotiating process as well as the overall management of investor relations following the close.[3]

Lately, there are signs that the search fund model, which by no means is commonly understood in the business community or even in private equity circles, has begun to become more established. Several private equity firms have begun investing in search funds and a fund with that specialty has been established. This trend provides greater support for the search fund concept and adds credibility to new search funds.

The target company

Searching for an acquisition target and completing a transaction can easily take over a year[4]. The general economic environment, industry characteristics, sellers' willingness to sell, and regulatory issues are among the many factors that can prolong or derail the acquisition process. Depending on deal complexity, it can take six months or more from the time the search fund signs the letter of intent until the deal closes.[5]

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[3] Search Fund - Frequently Asked Questions, Stanford website
[4] Search Funds - 2003: What Has Changed Since 2001?, Stanford website
[5] Search Funds - 2003: What Has Changed Since 2001? Stanford website

The search itself is described by search fund principals as a very demanding and repetitive process involving cold calling of potential targets, industry associations, business brokers, accountants, and bankers. Nevertheless, in order to execute a focused search, search funders strive to understand the characteristics of target industries and companies through the use of a defined set of criteria.

An example for industry screening parameters is as follows:

- *Fragmented industry* – Targeting industries that are highly fragmented, have no dominant player, or have numerous companies with relevant revenue ranges.
- *Market growth* – Focusing the search on industries that are historically stable to growing and are forecast to continue to grow.
- *Stable industry structure* – Target companies that have solid fundamentals and low operating risk. Consider:
    - Stable revenues – Industries that derive significant revenues that can provide a strong foundation for performance improvement.
    - Attractive industry economics – Good cash flow and profit margins can help increase the interest coverage ratio and allow for considerable debt leverage.
    - Stable operational structure – The fund principals will benefit from an initial period of relative calm to learn how to operate the business before making significant changes.
- *Straightforward business model* – Target industries that are familiar so that new management and lenders will quickly be able to understand industry parameters and identify profit levers.

Target company screening parameters include the following:

- *Size* – The search fund format provides limited access to capital. Therefore the target company revenues should be limited to a relevant range.
- *Company growth potential* – The company's ability to realize revenue growth through improvements in sales and marketing, product mix, or geographic coverage is important.
- *Product sustainability and differentiation* – Companies with products characterized by low obsolescence, minimal dependence on new technologies, achievable product differentiation, and limited seasonality are preferred.
- *Stable cash flows* – Stable cash flows during the post-acquisition period and before implementation of new management practices will increase the chances of success. Furthermore, stable cash flows will ensure the company's ability to meet its post-acquisition debt payments and protect against unforeseen operating issues.
- *Strong middle management team* – A committed, capable group of middle managers will be important to facilitate the transition to new ownership and help in the subsequent running of the company. They will also likely bring institutional memory and important client relationships.
- *Exit opportunities* – In order to provide the investors with liquidity within 4 to 7 years, the fund principals should analyze the prospective targets from the perspective of future potential buyers, either larger corporations or perhaps larger financial entities, including private equity funds.

Distressed companies are typically not viable targets because they require elaborate turnaround expertise and consume attorney fees if bankruptcy court is involved. Usually, search funds will be focusing on businesses where the current management team wishes to retire or reduce involvement in the company. By adhering to a disciplined list of acquisition parameters, search fund principals can greatly increase their probability of success. See a scoring example in Figure 1 below.

Figure 1 - Matrix Scoring Example[6]

		Coffee Service	Fire Extinguisher	Taxi Service	CO2 Distribution	Towing Companies	Adult Day Care	Pallet Recycling	Box Recycling	Septic
3	Many Entry Points	3	3	3	3	3	3	1	2	3
3	Low Operational Complexity	3	3	3	3	3	2	3	3	3
3	Sustainable Competitive Advantage	2	3	2	3	2	1	2	2	2
3	Roll-Up Potential	3	2	2	2	2	1	2	2	2
2	Entry Point <$15M	3	3	3	2	3	1	2	3	3
2	Can be Scaled /Grown	2	3	3	3	3	2	2	2	2
2	Leverages Systems Skills	2	2	3	2	3	3	3	2	2
2	"Rising Tide"	2	2	2	2	1	1	2	2	2
2	Low Business Cycle Exposure	3	3	2	2	3	1	1	1	3
2	Few Exogenous Variables	3	2	3	3	1	3	3	2	3
2	Low Seasonality	3	3	3	1	1	3	2	2	2
2	Not Core to Customer's COGS	3	3	3	2	2	3	3	3	3
2	Recurring Revenue	3	3	1	3	2	3	3	2	2
2	Threat of Technical Obsolesence Low	3	3	3	3	3	3	2	3	3
1	Northeast Entry Point	3	3	3	2	3	3	2	2	3
1	Add-On Sales/Service Potential	2	1	1	2	1	3	1	1	1
1	EBITDA margins 20%+	2	3	3	2	2	2	2	1	2
1	Trojan Horse Marketing	2	2	1	1	1	2	1	1	1
		96	96	90	86	81	77	76	76	87

The acquisition

Once an attractive target company is identified, the closing process normally requires:

- Negotiating an offer and issuing a letter of intent
- Issuing a term sheet
- Conducting due diligence
- Drafting a purchase and sale agreement
- Raising debt financing
- Raising equity financing

[6] Thoughts on a Search Fund Industry Screen, Stanford website

Search funders mention that qualifying the seller is a key priority in the purchase process[7]. Some business owners like to talk to someone who is interested in their business, but are not even remotely ready to sell. Others want to check the market value of their company but also have no intent to sell. Getting access to financial statements and establishing general parameters for the price early on is a way to validate the seller's commitment to the process. Understanding if the seller has non-financial motivations such as ensuring the location of the business in the community after his/her retirement may make the difference in a competitive situation.

It is essential to have a specific plan early on for what can be done to improve and grow the target company. At the same time, the acquisition process can be long, and deals may fall apart right at the last minute, so becoming emotionally attached to a transaction is a mistake. Attorneys, agents and advisory board members can be useful sources of insights and alternatives during negotiations.

Acquisition financing usually includes a combination of investor capital, bank debt, and seller financing.

- *Investor capital* – A transaction can be structured with offerings to investors of both equity and subordinated debt. Through the subordinated debt, investors receive attractive current returns. The equity portion allows the investors to participate in the expected upside from the eventual growth and sale of the company.
- *Bank debt* – Senior bank debt, including term loans and revolving facilities, comprises a significant portion of the acquisition financing. The actual percentage varies with the asset intensity of the company, interest coverage ratios, as well as the general banking climate at the time of transaction. The bank that has historically provided loans and other services to the target company can sometimes become the lead lender for the transition to new ownership.
- *Seller financing* – Sellers will sometimes stay involved post-closing with debt instruments, earn-outs, or consulting contracts. Each of these can provide an important source of funding for the transaction. Such funding may be relatively inexpensive, and would also help align the seller's incentives with that of the fund. The availability and extent of seller financing is influenced by several criteria, including the seller's need for immediate liquidity, tax situation, and desire to remain connected to the business.

Managing the company

An approach to the improvement process is to proceed in phases:

- *Analyze and learn the business* – The principals can focus on analyzing and thoroughly understanding the acquired business while simultaneously building

[7] Search Fund – Frequently Asked Questions, Stanford website

relationships with employees, customers, and suppliers. Absent an outside event or significant underperformance by a key employee, it is best to run the company as it has been run in the past. The employees and the company culture are evaluated.
- *Adjust the value growth plan* – The principals can work together with key middle management to refine the plan originally developed before the transaction closed.
- *Execute the plan* – The effectiveness of the plan should be reviewed periodically to generate continuous improvement and adaptation to the changing business environment.

Management's equity participation

Principals can earn a sizable share of the total equity in several ways:
- *Equity grant upon acquisition* – Upon successful closure of acquisition the principals receive an initial equity stake.
- *Cliff vesting* – After a predetermined number of years, the principals receive an equity stake.
- *Time vesting* – The principals can receive a portion of prescribed equity monthly or quarterly.
- *Performance based* – If the company achieves certain goals the principals receive equity.

Often the principals will combine some of these options in order to create a structure that aligns incentives of both the principals and investors. Table 1 below shows sample terms from actual search funds.

[see next page]

Table 1 - Structure of Search Fund Acquisitions (Deals Closed 1997 - 2003)[8]

	Fund #1	#2	#3	#4	#5	#6	#7	"Average"
Convertible Preferred, Redeemable Preferred, or Common Stock?	RP	CP	RP	-	RP	RP	All common	2/3 Redeem.
Preferred Return	8%	10%	16%	-	9%	0%	N/A	9%
Split mezzanine debt / equity?	50/50	No	50/50	-	50/50	No	No	1/2
Equity:								
Search	8%	15%	8%	10%	12.5%	0%	None	9%
Vesting	8%	15%	8%	10%	12.5%	20%	20%	13%
Vesting term	4 years	4 years	4 years	4 years	3 years	5 years	5 years	4 years
Acceleration clause? (1)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Performance	8%	0%	11%	10%	0%	5%	5%	6%
IRR Hurdle	20-40%	-	35% - 50%	-	-	40%	30%	20% - 50%
Total equity	24%	30%	27%	30%	25%	25%	25%	27%
Salary	-	$100k	$125k	-	$150k	-	Market	-
Bonus	-	-	-	-	30%	-	20-30%	-

Note:

(1) Acceleration vesting clause – equity is vested based on an event, typically liquidity or dismissal other than for cause.

[8] Search Fund Deal Economics, Stanford website

Exit strategy

While subordinated debt repayments can provide some returns, investors benefit primarily from management's ability to increase the value of the acquired company. The time horizon to liquidity is usually 4 to 7 years, although the investors and the principals may jointly decide to maintain their investment longer either to receive dividends from continued strong cash flow or to better time the sale to market conditions.

A search fund can create liquidity for its investors through one or more of the following routes:

- Sale of the company to a strategic or financial buyer
- Stock repurchased by the company
- Stock purchased by new or current shareholders (including management)
- Recapitalization of debt structure and dividend payout
- Initial public offering

Exhibit 1 - Comparison of Search Fund Principals' Profiles: Pre-2001 vs. Post-2001[9]

Categories	**Pre-2001**	**Post-2001**
Professional Background:		
Management Consulting	26%	23%
Investment Banking	23%	10%
Sales	12%	1%
Venture Capital	8%	3%
Line/General Management	5%	27%
Marketing	5%	2%
Law	4%	0%
Operations	4%	7%
Entrepreneur	2%	13%
Accounting	2%	0%
Engineering	2%	0%
Military	2%	1%
Insurance	2%	1%
Private Equity	1%	5%
Others 3	0%	7%
Age at Start of Search:		
Minimum	26	28
Median	30	31
Maximum	35	60
Gender:		
Male	96%	100%
Female	4%	0%
Number of Post-MBA Years Before Search Fund:*		
Minimum	-	0
Median	-	2
Maximum	-	10

* Note: Applies to search funders with MBAs only. Data was not collected pre-2001.

[9] Search Funds - 2003: What Has Changed Since 2001?, Stanford website

Exhibit 2 - Aggregate Metrics of Search Funds: Pre-2001 vs. Post-2001[10]

Categories	**Pre-2001**	**Post-2001**
Number of Principals:		
Single	68%	41%
Partners	32%	59%
Amount of Initial Capital Raised:		
Minimum	$40,000	$125,000
Median	$290,000	$350,000
Maximum	$1,000,000	$10,000,000
Number of Search Fund Investors:		
Minimum	2	1
Median	12	12.5
Maximum	25	20
Number of Months Fund-Raising:		
Minimum		1
Median		4.5
Maximum		9
Number of Months Searching: (as of 4/2003)		
Minimum	5	0
Median	18	8.5
Maximum	54	18
Targeted Industries:*		
Service	50%	30%
Manufacturing	19%	30%
Manufacturing/Service Combination	12%	0%
Distribution	8%	5%
Retail/Service Combination	8%	3%
Retail	4%	0%
Media	-	13%
Utilities	-	6%
No Preference	-	13%

* Note: The 2001 column refers to the sectoral distribution of **acquired** search fund companies, while the 2003 column refers to the distribution of industries **targeted** by sixteen post-2001 search funds.

[10] Search Funds - 2003: What Has Changed Since 2001?, Stanford website

Exhibit 3 - Summary Statistics for All Search Fund Acquisitions

	Minimum	Median	Maximum
Purchase Price [1]	$ 0.56	M $ 5.4	M $ 30.6 M
Search Fund Investor Capital Raised for Company Purchase	$ 0.0 M	$ 2.0 M	$ 7.0 M
Company Revenues at Purchase	$ 0.37 M	$ 7.1M	$ 43 M
Company EBITDA at Purchase	$ (1.6) M	$ 1.0 M	$ 4.5 M
Company EBITDA Margin at Purchase	(3.7)%	16.5%	42.1%
Purchase Price / Revenue Multiple	0.3x	0.9x	3.4x
Purchase Price / EBITDA Multiple [2]	2.3x	5.3x	12.5x
Company Employees at Purchase	12	80	740

Notes:
1. Summary statistics are based on financial information provided by search funders themselves. In many cases, this financial information has not been audited. Information regarding a small number of acquisitions was incomplete.
2. The minimum is calculated by excluding all negative EBITDAs.

Exhibit 4 - Search Fund IRRs to Original Investors[11]

	2001 Study Figures	2003
Individual IRRs: [1]		
Minimum	(100)% [2]	(100)%
25th Percentile		(100)%
Median	17.6%	(23.7)%
75th Percentile		21.9%
Maximum	98.3%	84.8%
Aggregate IRRs with Same Starting Dates:		
Actual Cash Flows with Original EBITDA Multiples	37.6%	31.7%
Normalized Cash Flows with Original EBITDA Multiples	36.8%	33.4%
Actual Cash Flows with Estimated Current Multiples minus 30% Discount [3]	35.7%	33.0%
Normalized Cash Flows with Estimated Current Multiples minus 30% Discount [3]	35.9%	34.7%

Notes:
1. Summary statistics are based on financial information provided by 36 funds that were either closed, or have sold or operated acquired companies for more than a year. In many cases, this financial information has not been audited.
2. Negative 100% in the "Minimum" column equates to a total loss of investor capital.
3. When firms elected not to provide an estimate of current EBITDA multiple, the original multiple was used. When respondent provided a range of EBITDA multiple estimates, the average figure was used.

[11] Search Funds - 2003: What Has Changed Since 2001?, Stanford website

Sources

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