The First 10 Questions for Would-be Searchers

Question 1. What is a Search Fund?

The Basic Search Fund Structure

Search Funds are a niche asset class that has historically been focused on the U.S. market. These investment vehicles enable high-potential and entrepreneurially minded individuals or partnerships to locate, acquire, manage and grow privately held companies.¹ For many prospective entrepreneurs, search funds offer a rare opportunity: The possibility of becoming an equity-owning business manager early in their career. This process is described in detail by the Stanford CES Search Fund Primer¹ and falls into four distinct stages.

Stage 1 – Raising the Search Fund

In this stage, the entrepreneur(s) raise search capital for their search fund. The purpose of this capital is to pay the searcher(s) a salary for approximately two years and to cover search-related expenses (such as overhead, due diligence on potential acquisitions, etc.). Typically, the initial search fund consists of 10 to 20 units, at a price of $20,000 to $30,000 per unit.¹ According to the most recent study on search funds,² the total search capital raised is typically between $290,000 and $450,000.²

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¹ At an exchange rate of €1.40/USD, $20,000 to $30,000 equates to €14,285 to €21,428.
² At an exchange rate of €1.40/USD, $290,000 to $450,000 equates to €207,143 to €321,429.
Stage 2 – Search and Acquisition

In this stage, the entrepreneur(s) identify potential acquisition targets and, if a suitable target is found, attempt an acquisition. Potential acquisition targets should fall within a specific set of criteria defined by the searcher(s) and agreed upon by Stage 1 investors. Several common criteria include geographic location, industry, EBITDA margin, and Enterprise Value. Before making an acquisition, a typical search fund will have identified over 300 potential targets. However, the strictness of the search criteria, the due diligence process and negotiations results in a demanding acquisition funnel. Once the due diligence is complete and the deal has been negotiated, the final acquisition is funded through equity (usually from the original investors, though sometimes supplemented by other investors) and debt (usually a combination of bank and seller debt).

Stage 3 – Operation and Value Creation

In this stage, the entrepreneur(s) take on a key operational role within the acquired company. This role is typically at the CEO or equivalent level and the entrepreneur(s) is generally expected to remain in this role until an exit is achieved. During this stage, the entrepreneur(s) executes their plan to grow the business and create value.

Stage 4 - Exit

In Stage 4, the entrepreneur(s) provides investors with a liquidity event. This may take the form of an IPO, sale to a strategic buyer, etc.

Duration of a Search Fund

The median life cycle of a search fund is over eight years (see Figure 1 for the historical durations of each stage) and demands a large commitment from the searcher(s). Prospective searchers should be aware that, once committed, there are limited opportunities to exit the search fund and should consider how this commitment will impact their personal and professional lives in the years to come.
Figure 1
Duration of search fund stages in months

Characteristics of Target Industries and Businesses

Most Search Funds have been raised by MBAs (either newly minted, or with a few years of post-MBA experience). As such, they tend to be high-potential, but relatively inexperienced operators. In addition, investors expect high returns on their investment (usually in the 30% IRR range). In order to increase the odds of success and to achieve the expected returns, search funds target businesses that meet very strict criteria. Some of the most common criteria are described in Appendix 1.

Additional Resources


Question 2. How is a Search Fund Different from Private Equity or Venture Capital?

Venture Capital

The BVCA describes venture capital funds as typically

“... back[ing] concepts or ideas brought to them by entrepreneurs or young companies looking for financing to help them grow. Since businesses at the concept stage are nascent, venture capital investors will take a disciplined approach to evaluating not only the viability of the business idea, but also the motivation and background of the entrepreneur.”

In comparison, search funds typically target established profitable businesses that have a high potential for growth. These businesses are often mature (in contrast to being in the conceptual stage), but are well positioned for another period of growth. Moreover, search fund investors are typically investing in the potential ability of the entrepreneur (the searcher) to run and grow an already healthy business - in essence, in the viability of the searcher as a strong manager.

Private Equity

The BVCA defines private equity as, “a medium to long-term finance provided in return for an equity stake in potentially high growth companies, which are usually, but not always, unquoted.” Based on this definition, a search fund is clearly a private equity vehicle. However, search funds further restrict the private equity definition. More specifically:

Search Funds Look to Acquire a Controlling Interest in a Healthy Company

Search funds are explicitly seeking a controlling interest (if possible, usually 100%) of a healthy firm and will replace the incumbent top management upon acquisition. Moreover, it is the principles of the search fund who identify and acquire the business, and who take over the management role. In contrast, private equity covers a much broader range of opportunities. For example, healthy or distressed businesses may be targeted, majority or minority interests may be sought, and management may or may not be replaced.

Search Funds Typically Target Smaller Businesses than Traditional Private Equity Funds

One of the strengths of the search fund model is the human capital it provides investors with. Searchers are typically talented individuals who would command significantly higher salaries.

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3 The BVCA is the leading industry body and public policy advocate for the private equity and venture capital industry in the UK.
in a traditional corporate role or at a private equity fund. In exchange for this discounted salary, searchers receive an equity stake in the acquired company. This “discount” reduces the cost of sourcing potential deals for investors and provides them with potentially higher returns and access to smaller deals that cannot be targeted by a conventional private equity fund – to recoup the sourcing costs of a larger deal, investors require higher returns on a same-size deal or the same return percentage on a larger deal.

**Additional Resources**


British Private Equity & Venture Capital Association (BVCA), http://www.bvca.co.uk/home.

**Question 3. Why Set up a Search Fund?**

Prospective searchers find this model attractive for several reasons. First, for many would-be entrepreneurs, coming up with an idea for their business is a major hurdle, even one that proves impossible to overcome. The search fund model removes this hurdle by shifting the focus to evaluating existing businesses and their potential for growth.

Second, many talented and ambitious individuals strive to run a company. However, it is very difficult to obtain these positions early in one’s career – a typical career requires these individuals to invest significant time before they are able to progress to the top levels of an organization. In contrast, a search fund provides these individuals with the opportunity to run a company early in their career.

Third, a search fund has two attributes that make it lower risk than a startup for the entrepreneur. Because a search fund targets an existing and profitable business, a significant portion of the business risk associated with a startup is eliminated. A profitable business is in essence a validated business model: the business concept has value in the marketplace and the business model effectively captures that value. Moreover, an existing business already possesses a certain amount of organizational, process, and IT infrastructure which supports the continuing of operations and can be a platform for growth. The second risk mitigation factor is the search fund itself. In particular, the entrepreneur receives a salary throughout the search process, and the investor group of a search fund can be an invaluable source of mentorship and guidance that early-stage companies do not always receive.

Finally, a search fund may provide the entrepreneur with a broader experience than is available elsewhere. The life cycle of a search fund is extremely demanding on the entrepreneur, in large part because of the broad range of roles they are asked to fulfill. For example, the entrepreneur must be able to raise capital to begin the search fund, source deal flow, identify attractive industries, evaluate deals, execute an acquisition, guide a management transition, lead an operating company, grow a business, find an exit opportunity for their investors, and execute the exit. Few, if any roles exist that offer such a broad experience.
Question 4. Why Would an Investor Fund you to Find a Company to Buy and Run?

For the uninitiated, this is one of the most difficult questions to answer. However, proponents put forward several compelling arguments for why some investors find search funds so attractive. The following are the most commonly cited reasons. It should be noted that this is not an exhaustive list, and as with any investment, each individual investor has their own list of reasons why they choose to invest.

Returns

Clearly, returns are an important consideration for any investment decision, and search funds have historically performed very well (over 30% IRR, depending on the time frame and companies included/excluded). This compares favorably to many other alternative investments and is probably the most compelling reason to invest.

However, it is important to realize that these are average returns and that individual returns vary widely. As a consequence, those investors who like this model tend to invest in a portfolio of search funds, a tendency that explains why the same investors keep showing up in fund after fund.

The Initial Investment is an Option on You

The search fund model consists of two rounds of financing. The first round raises a small fund to support the searcher(s) while they source and carry out a deal. For investors, this round of financing amounts to little more than an option on the searcher(s) – this investment is small compared to the second round of investment (typically an order of magnitude smaller) and gives the investor the preferential right to participate in the final deal. For supporters of search funds, the option characteristics of this investment are a major reason to participate.

Risk Mitigation

Search funds mitigate risk for investors in significant ways. First, a search fund allows investors to make an extended and detailed evaluation of the entrepreneur. Over the course of several years, as the entrepreneur raises search capital and searches for an acquisition, investors will witness firsthand the entrepreneur’s work ethic, judgment, persistence, and adaptability. Moreover, investors are in a position to help develop the entrepreneur through mentorship as they move through the process.
Second, investment in a search fund is staged and back-ended. Rarely are investors given the opportunity to make a small upfront investment (search capital) and evaluate management and the acquisition opportunity before making the significant investment of acquiring the target (investors are not obligated to participate in the acquisition). This option nature of the search fund further reduces the risk to investors.

Access to Deals

In principle, Search Funds target small and mature companies (usually in the range EBITDA $1-3 million) for acquisition. Companies of this scale are smaller than the ones that many investment vehicles, such as private equity funds, typically pursue. For larger funds, the cash value of the upside may not be large enough to warrant the effort and cost of sourcing a deal. Search funds overcome this cost hurdle by employing talented but inexperienced professionals (typically new MBA graduates) at a discount. These professionals (searchers) work at a discount because of the possibility of running and earning equity in a business much sooner than they otherwise would be able to. The result is that investors are able to source deals at a relatively low cost (the option value), and in a segment (defined by deal value) with relatively little competition.

Additional Resources


Question 5. Who Invests in a Search Fund?

Search Funds have typically been funded by wealthy individual investors who are capable of taking a portfolio approach to this type of investment. However, a more important question is “Who would be a good investor for my search fund?” For many entrepreneurs trying to raise funds for the first time, the temptation is often to take whatever money they can get from wherever they can get it from. In contrast, many successful searchers and investors cite picking the “correct” investors as being just as important as the funds they provide. Beyond being a source of capital, the investor group can, and ideally should, provide much more.

In general, investors can be classified in broad categories, but many investors will have attributes from several categories. A strong investor group will be composed of investors from all of these categories and will complement the searcher’s existing network and skill set.

Investors Who Know the Searcher Personally

These investors are often the first investors in the fund. While they know the searcher personally, they may or may not be familiar with the search fund model. However, they
believe in the searcher because of their personal experience with them and are willing to invest on this basis. Moreover, these investors often know the searcher from their previous employment and have deep knowledge of the industries in which the searcher is experienced – these are often the industries the searcher will target. For subsequent investors, the presence of these investors is a significant vote of confidence for the individual and may be the difference between investing and not investing.

**Experienced Search Fund Investors**

Experienced search fund investors know the model well and understand how the search process works. For investors who are new to the model, the presence of these investors suggests that the searcher has the potential to be successful – they have been vetted by an investor who knows what it takes. Moreover, these investors know how previous deals have been structured and can act as a guide through both of the funding stages (raising the search capital and raising the acquisition capital).

**Local Investors**

These investors understand the investment environment of the targeted geography. They can provide guidance on the local legal and regulatory requirements, tend to have strong ties with local intermediaries and professionals (lawyers, accountants and bankers), and tend to be well connected with the community (which can help generate deal flow). The knowledge and connections of these investors can have a significant impact on the success and efficiency of the search, acquisition, operation and exit phases of a search fund.

**Industry Experts**

These investors have expertise in the industries of interest for the search. Their knowledge, experience and contacts within these industries can be invaluable for finding and evaluating an acquisition prospect.

**Capital Investors**

These investors have access to larger pools of capital for acquisitions. It is not uncommon for several of the initial investors to choose not to participate in the acquisition. In these cases, additional capital must be found. Investors with the capacity to come up with significant additional capital can be critical to completing an acquisition.

**Mentors**

Throughout the search fund life cycle, the searcher will be asked to take on roles that will be unfamiliar to them. Investors with strong operational experience and who are interested in, and capable of, mentoring the searcher at various stages may be key to the success of the search fund.

While raising their search fund, searchers should continually evaluate the attributes of their investor group. Furthermore, searchers should consider the cost of acquiring the types of
investors that they need. For instance, obtaining a strong capital investor may require the searcher to accept a partial unit investment in the search fund (the capital investor may be more interested in the acquisition and wishes to invest as little as possible to have access to the deal). Similarly, obtaining other investors may require accepting investors with a limited capacity to participate in the acquisition (meaning significant additional capital may be required at acquisition time). By actively managing the composition of their investor group, the strengths and weaknesses of different investors can be balanced and the searcher can significantly improve the odds of a successful search.

**Additional Resources**

Stanford Graduate School of Business, “Search Funds: The Investors Perspective,” video file, 
http://youtu.be/py1Pa7f22rE.

Stanford Graduate School of Business, “Best Practices for Conducting a Search: Panel Discussion,”
day/month/year, video file, 
http://www.youtube.com/watch?v=fXpt8xYgN0A&feature=relmfu.

**Question 6. Where Should you Search?**

Search funds target specific geographic regions and industries in their search for acquisition opportunities. Due to the vast array of small businesses that exist, these restrictions are necessary and help the searcher focus on areas where they are most likely to succeed.

Most searchers choose to prioritize geographies that they know well– familiarity with the geographic region is chosen over fast growing regions (such as India and China). This is both a practical and a personal choice. From a practical standpoint, the searcher must be able to legally acquire a business in the region of choice, should be familiar with the business practices there and should be a good cultural fit (i.e. language, religion, etc.). However, these factors are the minimum requirements to successfully operate a business. In addition, a search fund requires the entrepreneur to raise money for the search and to generate deal flow, and in particular, proprietary deal flow. In both of these activities, the searcher’s personal network is an invaluable resource. As such, searchers tend to focus on regions where their network is already strong.

The personal considerations of the search geography are a direct result of the time commitment demanded by a search fund - the life cycle (from raising search capital until exit) of the median search fund that successfully acquires, grows and exits a business is over 8 years.[1] The length of this period dictates that searchers must also consider the implications of their region of choice on their personal life. Consequently, many searchers restrict their geographical focus for personal reasons.

The industry focus of a given search fund is typically dictated by the specific requirements of the search fund model and a combination of industry characteristics and the searcher’s experience and skills. For example, the search fund model inherently demands rapid growth (investors typically expect IRRs of more than 30%), and a profitable and growing industry makes achieving this level of growth much easier. Similarly, the searcher’s experience and
skills may be better adapted to certain industries, and the searcher may be well served to focus on businesses in these industries.

Unfortunately, there is no short answer as to where the search should be focused. Nonetheless, it is a question that must be answered before starting a search fund. Fundamentally, the choice of target geography and industries is a question of where is the searcher most likely to succeed. The searcher must evaluate for themselves what geographies they are best suited to (personally and professionally), what industries are best suited to the demands and restrictions of the search fund model, and what type of businesses they are most likely to add value to. With these questions answered, the searcher can identify the best combination of geography and industries for their search.

Finally, while targeting a specific geography and set of industries will help the searcher focus on opportunities that are more likely to meet their investment criteria, it is important to recognize that these are soft restrictions. A typical search fund evaluates over 300 potential opportunities before making an acquisition, and the search focus must be broad enough that sufficient deal flow can be generated. Moreover, many searchers have been well served by being open to opportunities that fell outside their initial strict criteria, and even the most focused search should remain open to these possibilities.

Additional Resources


Question 7. What is the Search Fund Payment Scheme?

The payment scheme of the search fund model is both potentially lucrative and heavily dependent on performance. While the searcher does earn a salary throughout most of the search fund’s life cycle, this portion of the compensation tends to be substantially below what could have been earned in an alternative career. To compensate for this, the searcher earns equity in the company they acquire and participates in the returns they generate for shareholders upon exit.

An equity scheme for a search fund typically gives the searcher the opportunity to earn more than 20% of the common equity in the acquired company. The equity stake is usually earned based on three metrics. At acquisition, the searcher typically earns the first portion of their potential equity stake. The second portion is frequently earned over time, and the final portion is often earned based on the exit IRR. It should be noted that the precise amount of equity that the searcher can earn and the metrics it is tied to are negotiated with investors and may vary from what is described here.

Without question, the potential to earn a substantial portion of the acquired company’s equity makes search funds very attractive. However, potential searchers should note three important effects of the search fund structure.
Investor Capital is Senior to Common Equity

While the potential equity stake in the acquired company is significant and the potential payoff is large, searchers should be aware that the investor capital is senior to the common equity earned by the searcher. In a typical acquisition, the investor capital comes in the form of preferred equity and subordinated debt. As such, the common equity, the equity that the searcher participates in, is junior to the investor capital, and the searcher only participates in the upside after the investor's capital has been returned. Moreover, the investor capital usually has a coupon or dividend associated with it (frequently capitalized), meaning that the pool of investor capital grows at a compound rate over time. As a consequence, for the common equity to grow in value, the company must generate value faster than the rate at which the pool of investor capital is growing. If it does not, the value of the searcher's equity stake will be zero.

Search Capital is Diluting to Your Equity Position

For would-be entrepreneurs, search funds often appear attractive because of the pool of funds raised to fund the search process. While these funds do reduce the initial risk to the entrepreneur by paying a salary and expenses, they come at a substantial cost. A typical search fund will have a 50% step-up on the search capital at acquisition. This means that $400,000 of search capital will be converted to $600,000 of investor equity at acquisition. This acts as a burden on the entrepreneur's equity, as this capital must also be returned before value begins to accrue to the common equity. As a consequence, potential searchers should carefully consider how much search capital must be raised, and its impact on their equity stake.

The Greater the Potential Equity Stake, the Harder it is to Achieve the IRR Hurdle

Many potential searchers believe that the larger the potential equity stake the better off they are. In the most optimistic case, where they earn all of their equity, this is certainly the case. However, a significant portion of the equity is tied to the investor's returns (typically measured with IRR), and a larger potential equity stake may make it harder to earn the full equity stake. More specifically, because the entrepreneur is entitled to a greater portion of the common equity, the company must grow more for investors to receive the same IRR on their investment (they are entitled to a smaller proportion of the value created). As a consequence, entrepreneurs who push for a higher potential equity stake may find themselves with a smaller piece of the pie at exit than if the potential stake were smaller.

**Additional Resources**

“A Primer on Search Funds - A Practical Guide to Entrepreneurs Embarking on a Search Fund,”
“Stanford Center for Entrepreneurial Studies, date.

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4 At an exchange rate of €1.40/USD, $400,000 equates to €285,714.
5 At an exchange rate of €1.40/USD, $600,000 equates to €428,571.
Question 8. What is the Downside?

A search fund is a risky undertaking. As an entrepreneur, the downside is split between the financial performance of the search fund, the opportunity cost of pursuing a search fund, and reputational risk.

Downside Due to Financial Performance of the Search Fund

The strong returns of search funds as a group (IRR of 37% according to a 2009 Stanford study(2)) are widely distributed and a minority of search funds deliver positive returns. The following excerpt from Stanford’s 2009 Study on Search Funds(4) illustrates the significance of this risk:

“Return data was calculated for 79 funds ... Of these 79 funds, 59% suffered a partial or complete loss of capital. However, about a third of these were instances where no acquisition was made, so only the initial search capital was lost. Because of these ‘low-cost’ failures, these 59% of funds represent only 44% of capital invested (search capital and acquisition capital provided by search fund investors). Similarly, 38% of funds (representing 56% of capital invested) produced a gain for investors. Two funds shut down and returned all capital invested after the principals elected to pursue a different model.”

This distribution has serious implications for search fund entrepreneurs – the potential value of the earned equity is a significant portion of their expected compensation, and negative returns equate to zero equity value for the searcher. However, the high aggregate return numbers of search funds indicate that successful funds are delivering significant returns to both investors and entrepreneurs.

The Opportunity Cost of a Search Fund

Prospective searchers should be wary of the potential opportunity cost of a search fund. A searcher’s compensation is a combination of a discounted salary while searching (and likely while operating) and the highly uncertain value of the searcher’s equity interest in the acquired company. This compensation structure dictates that if strong returns are not achieved, or an acquisition is not completed, the searcher will bear a significant opportunity cost.

For many searchers, the fact that their compensation is heavily weighted towards equity drives them to make an acquisition. While this is the intended incentive, searchers should also recognize that making a bad deal is far worse than not making a deal at all. In the event of a poor acquisition, the searcher’s opportunity cost increases dramatically, as they dedicate months, and often years, of their career to a business that will realize little, if any, equity return.

The Reputational Risk of a Search Fund

A search fund is an incredible opportunity to make or damage your reputation. A well-executed and financially successful search fund will change the trajectory of the entrepreneur’s career and cement their reputation. A poorly executed or financially disastrous one can just as easily put a black mark on their reputation that will be difficult to shake.
Many prospective searchers see failing to make an acquisition as a negative. However, so long as the searcher has worked hard, experienced investors disagree. A searcher who has given their best effort but has not made an acquisition likely has the discipline to avoid making a deal just for the sake of it. Moreover, making a poor deal may have serious consequences for the entrepreneur’s career and their reputation with investors. Similarly, the impact of the financial performance of the acquired company on the entrepreneur’s reputation is very dependent on the performance of the entrepreneur – a business that fails because of the manager’s poor decisions is very different from one that fails in spite of the manager’s good decisions.

In short, the reputational risk/reward of a search fund is dependent on the perceived quality of the decisions made by the entrepreneur and is amplified by the resulting financial performance of the search fund.

Additional Resources


Question 9. What Does it Take to Succeed as a Searcher?

The life cycle of a search fund is very demanding on the entrepreneur and not all individuals are well suited to this career. Functionally, the entrepreneur must be able to adapt to a wide variety of roles. Over the life of a search fund, the entrepreneur must be able to raise capital, source deal flow, identify attractive industries, evaluate deals, carry out an acquisition, guide a management transition, lead an operating company, grow a business, find an exit opportunity for investors, and execute the exit strategy.

Mentally, the entrepreneur must be able to cope with the long, demanding and lonely journey that is a search fund – the median life cycle of a search fund that successfully acquires, grows and exits a business is over 8 years.\(^{(1)}\) Many searchers cite the loneliness of the search process as one of the most difficult aspects of operating a search fund. In particular, there is the challenge of staying motivated while searching for an acquisition and as deals fall through (as they invariably do). Any searcher must be committed to a long journey.

Unfortunately, there is not a specific list of attributes or experience that describes an individual who is capable of meeting these challenges. However, anyone who is serious about search funds must consider what the experience will entail (functionally and mentally), what is required to successfully run a search fund, and whether or not they have the capability to meet these demands.
Question 10. I'm Interested. What do I do Next?

Search funds offer prospective entrepreneurs an excellent avenue into the world of entrepreneurship. However, search funds are likely not well suited for all prospective entrepreneurs. Entrepreneurship in general is a risky career choice with uncertain payoffs. Search funds are no different. Moreover, the relative security they provide to prospective entrepreneurs – a salary while searching, the acquisition of a proven business, committed soft capital, mentorship, etc. – also comes at a cost. This note, and the resources highlighted throughout, will help prospective entrepreneurs evaluate whether a search fund is right for them, and whether they are right for a search fund.

If you are convinced that a search fund is right for you, or you simply want to explore this career further, there are many resources available. Begin by reviewing as much material as possible on search funds. The links and resources referenced in this note are a good starting point and will help you understand many of the nuances of search funds. In particular, Stanford’s “Search Fund Primer”(1) and IESE’s “Considerations for Entrepreneurial Acquisitions”(5) provide a much more detailed account of what is required to run a search fund and the many challenges and nuances associated with them.

Once familiar with these documents, consider reaching out to the search fund community. The individuals within this community are very open and willing to assist serious potential searchers. However, it is important to be well informed before talking with searchers and investors, as this will greatly improve the quality of these conversations and enhance your credibility.

Additional Resources


Appendix 1
Common Criteria for Search Funds

Below is a list of some of the most common criteria used by search funds for targeting a business. However, readers should note that it is unlikely that a searcher will find an industry or a business that meets all of the criteria listed below. Moreover, individual funds will have different criteria based on the type of opportunities seen in the marketplace and the individual skills, experience and attributes of the entrepreneur.

**Industry Criteria**

* A growth industry
  A growing industry makes it much easier to grow a business than a stagnant or shrinking one.

* An industry that is profitable, not in decline and attractive to the customer
  These attributes create a more favorable competitive environment for growth and may make it easier to obtain leverage.

* An industry with a large pool of acquisition candidates
  The prospect universe must be large enough to find a business that meets the acquisition criteria and must have an owner that is willing to sell at a reasonable price.

* Financing available
  The availability of leverage has a significant impact on the potential returns for investors.

* No overly dominant competitor or customer
  The absence of a dominant competitor or customer may mean a more favorable competitive environment for growth.

* Limited landscape risk (including technology obsolescence, regulatory risk, legal risk, environmental risk, major cyclical risk, fads/trends)
  Limited landscape risk suggests a stable competitive environment with well-defined criteria for competition. This may make it easier for an inexperienced manager to manage the business.

* Low-to-medium technology product or service sectors, rather than the high-tech sector
  An industry with lower capital intensity (reducing the need for additional capital) and a lower risk of technological obsolescence.

* Growth potential via follow-on acquisitions, geographic expansion, and/or product/service extension
  There should be opportunities to grow the business by extending its geographic reach and/or product offering.

* Long product/service life cycles that are not subject to rapid technological change or obsolesce and that do not require substantial additional R&D
  Lower capital intensity and less risk of technological obsolescence.

* Product/service differentiation exists or can be created
  Makes it easier to grow or maintain high margins.
Appendix 1 (continued)

Business Criteria

*Profitability*
It is easier to operate a profitable business than an unprofitable one; thus turnarounds are usually excluded.

*Predictable, stable and recurring revenue*
This gives the experienced manager time to become familiar with the business and increases the potential leverage of the acquisition.

*High EBITDA margins*
Frequently over 15%. High-margin businesses are easier for a new manager to manage than low-margin businesses.

*Stable contractual relationships*
This gives the experienced manager time to become familiar with the business and increases the potential leverage of the acquisition.

*Simple and easy to understand*
Simple businesses have less complicated growth levers and reduce the time it takes for the inexperienced manager to become familiar with the business.

*Reasonable pricing*
It is hard to make great returns if the purchase multiple is too high.

*Competent middle management willing to remain*
Makes it easier for the inexperienced manager to become familiar with the business and creates a platform for growth.

*Cash flow and assets sufficient to attract and service proposed debt*
Makes it easier to obtain leverage.

*Opportunity for liquidity in 4 to 6 years*
Provides an exit for investors.

*The opportunity to create superior returns through revenue growth, operational efficiencies, scale, financial leverage and improved management techniques*
A clear opportunity to achieve significant growth.
Appendix 2
"Head of the Class"

Written by Thomas Zadvydas
Published July 11, 2011, in The Daily Deal

The beginning of search funds is the professional coming-of-age story of two Harvard Business School graduates, Jamie Turner and Kirk Riedinger, as they launched careers as newly minted M.B.A.s. Turner and Riedinger share the credit for raising the first search fund at Harvard in 1984. The two men forged a new investing model that provided a track for business school graduates with strong entrepreneurial instincts to blaze their way into executive leadership. A long climb up the corporate ladder was not required. Aspiring entrepreneurs needed only youthful tenacity and willingness to embrace risk and walk down an unconventional road. Indeed, even today the model the pair created, the funded search, doesn’t have a wide presence beyond its Harvard and Stanford University roots.

“I had six job offers at the time, and I turned them all down because I wanted to do this,” says Turner, vice chairman of Denver’s Alta College Inc., a trade school network he and Riedinger bought in 1987 for about $4 million. The company, acquired with capital from Turner and Riedinger’s $140,000 fund, currently runs about 19 schools with some 16,000 students, and rakes in about $340 million in revenue annually. “Our strategy has been to be in fairly large metropolitan markets. We’re in like six or seven of them now,” he says.

Success stories such as Alta are rare. But a number of companies founded by the search fund model have achieved notable success, chief among them Asurion, one of the world’s largest providers of cellphone insurance, which was sold to a pair of private equity firms for $4.2 billion 12 years after being purchased by a search fund for $8 million.

Search funds, or small pools of capital that seek to acquire and manage lower-middle-market companies, allow a would-be executive with ownership aspirations to buy his or her way into the CEO chair. The first known search fund was founded in 1984, according to a 2009 survey by the Center for Entrepreneurial Studies at the Stanford Graduate School of Business released in 2010. The idea for these little-known investing vehicles was hatched in a pair of serendipitous meetings, and by the collective vision of these two Harvard business school graduates, who were guided by an inspirational mentor, a teacher who believed strongly in the vocation of entrepreneurship.

Riedinger and Turner, after finishing their undergraduate work at Stanford in 1980 and 1981, respectively, tried their hand in the traditional corporate race. Turner spent two years as an analyst at Lehman Brothers Inc., while Riedinger held two jobs, one as a computer salesman for now-defunct Burroughs Corp. (which merged with Sperry Corp. in 1986 to become Unisys Corp.) and another as a consultant with a small firm called Cresap, McCormick and Paget (which would be acquired by New York consulting house Towers Perrin in 1982). Riedinger spent a year in Australia on an assignment with Qantas Airlines Ltd. while at Cresap McCormick. The two never discussed working together as undergrads in the same fraternity, but their paths crossed again in
Appendix 2 (continued)

the fall of 1983 when they each decided to attend Harvard Business School. In their second year, fate came calling in the form of an inspiring professor who would take the pair under his wing.

The two men credit H. Irving Grousbeck, then a professor at Harvard and currently a director of Stanford’s entrepreneurial studies center, for setting them down the search fund path. “We were at the time taking Irv Grousbeck’s class, which was entrepreneurial management,” Riedinger recalls, “and I would describe his class as a little bit of teaching the religion of entrepreneurship. Each class was a case study on somebody who had gone out and started a business, or bought a business.”

Turner remembers that the businesses they studied in Grousbeck’s class - ice cream stores and muffin shops, for instance - stood in stark contrast to the large corporate conglomerates such as Coca-Cola Co. and Procter & Gamble Co. that Harvard M.B.A. students typically prodded. The professor would often bring in self-made entrepreneurs to speak to his class. Riedinger and Turner say that Grousbeck had two main motives behind his unique teaching method. One was to keep his students engaged during long class sessions by introducing living examples, while the second was to show with impressionable force the validity of the entrepreneurial path. “[It] sent the message that these guys weren’t necessarily any smarter or richer, or whatever, than we were. They had just decided to go out and do something, and had accomplished it,” Turner says. “It was a subtle message, but it was an effective message.”

Like many aspiring M.B.A. students at the time, Riedinger and Turner were saturated by the finance stories covered heavily by the press in the mid-’80s, like the developing of the high-yield-bond market and the leverage buyout boom. “We wouldn’t have thought of that. Being in the middle of that era, Michael Milken and others were doing that. It was on the front page of The Wall Street Journal,” Riedinger says.

Inspired to forge their own path, Riedinger and Turner turned to Grousbeck for advice. “They came into my office one day, and they said, ‘We have an idea we’d like to hear your opinion on. We want to try to find a business to buy, and a classmate of ours has agreed to give us $20,000, and we think we can raise another $10,000 from our families. What do you think of the idea of us taking $30,000 and going to look for a small company to buy?’”

Grousbeck explains that he was intrigued by the concept but that he advised his young protégés to raise more cash. “I said, ‘That’s insufficient. You’ll need more time than that to get enough dealflow and enough choices and alternatives to make a good selection.’” By aggressively tapping professional and personal networks, the men managed to rustle up about $60,000 by the summer of 1985. “We put down a list of everyone we thought would be likely [investors]. That could be our coach, our teachers, family members, uncles, whomever,” Riedinger says. A dogged sense of determination and fearlessness served the two men well. “They were unafraid even then to pursue a path that was unpopular among their peers, [a path] frankly about which their peers were skeptical,” says Grousbeck, who continued to guide his students as they set out for a target.
Appendix 2 (continued)

Grousbeck says he invested in the first company the pair acquired. That company was Alta, originally known as the Denver Institute of Technology. Neither Turner nor Riedinger ever intended to work in the for-profit education space, and they cast a wide net before targeting Alta’s predecessor during the end of a tortuous journey from Boston to Los Angeles to Denver.

In 1986 the two men came close to acquiring a cosmetology school in Los Angeles but were unable to close a deal because of price disagreements. Riedinger and Turner eventually came across a cosmetology school in Denver that they almost bought. “We moved out, we had a big party in Boston, we said, ‘We’re off to Denver,’ and before we closed we kind of got some cold feet,” Turner recalls, adding that he and his partner ended up moving back to Boston and returning all the money raised for the acquisition and had to start with a fresh $80,000 search batch.

During their time in Denver, the pair met R. Wade Murphree, a principal owner of Denver Institute of Technology. Riedinger and Turner purchased the company for between $4 million and $5 million. They raised about $1 million and funded the remainder of the purchase price with a small senior loan from a commercial bank and a seller’s note that was paid back over time.

“When we really looked at it from a sort of M.B.A. analysis, it was very attractive. It had recurring revenue, high barriers to entry, it was import resistant and recession resistant,” Riedinger explains. Despite the businesses’ potential upside, the two men had to learn both basic managerial skills applicable to any company and the unique particulars of running a trade school. Two of the main challenges were developing effective communication skills in a people-intensive business and learning how to work in tandem with industry regulators, they say.

Riedinger remembers the challenge of two young managers dealing with packs of government watchdogs from agencies such as the Colorado Commission on Higher Education hounding them. “You really had to approach [them] as a partnership to be effective,” he says. “It wasn’t just simply, ‘We’ll just comply and then we’ll be OK.’ It was that you needed to work with the regulatory folks, keep them well informed of what you were doing, how you were doing it, why you were doing it, and be open to their guidance and input also.” Today investigations of the for-profit space come from a myriad of federal agencies such as the Federal Trade Commission, Government Accountability Office, the Securities and Exchange Commission, and the Department of Education, as well as state accreditation bodies like the Accrediting Commission of Career Schools and Colleges.

The two partners worked over the ensuing years to build up their company, mostly through organic growth. “The core of our strategy was opening new schools from scratch,” Riedinger says. The investor base also shifted over time. BCI Partners, Inc. bought a stake in Alta in 1999, and Housatonic Partners bought one in 2002. “We brought in some new money. We also retained some of our core investors,” Riedinger states.
Appendix 2 (continued)

An early Alta board member, Rob Johnson, says the partnership between these men was somewhat akin to a healthy marriage, a symbiotic bond whereby each person contributed something mutually beneficial. “It was clear they were a good match for each other. They complemented each other’s skills. Jamie took on the financial role and managed the finances, and managed them quite well. Kirk did more of the marketing-oriented and operational activities,” says Johnson, who was a former instructor at London Business School and who currently lectures on entrepreneurship and search funds at IESE Business School in Barcelona.

Some credit Boston investor Jim Southern with forming the first search pool. Southern, a well-known search fund investor, bought a printing company called Uniform Printing and Supply Inc. via a funded search in 1984. At the time, however, Southern only had one investor. Turner and Riedinger were the first to launch a search fund similar to the models used today. Their story continues to be instructive for the search fund community within Stanford and Harvard; the two now find themselves in front of a classroom extolling the virtues of self-entrepreneurship. “Irv wrote a case on us, and we would go back to Stanford and also to Harvard and be the guys that came into class and try to encourage the current generation to go out and do something [like this] if they had the desire,” Turner says.

In fact, it was another pair of Grousbeck’s students that expanded Asurion from an $8 million search fund acquisition in 1995 to one of the world’s largest providers of cellphone insurance, with more than 5,000 employees. Jim Ellis and Kevin Taweel bought the company when it was a 45-employee business called Road Rescue Inc. providing assistance insurance through local wireless carriers to their users. In 1999, they expanded into insurance for loss or damage to cellphones. Bolstered by three notable acquisitions in 2005 and 2006, Asurion grew to a company with $2.5 billion in revenue. In 2007, Ellis and Taweel sold the company to Providence Equity Partners LLC and Madison Dearborn Partners LLC for $4.2 billion.

Riedinger and Turner, meanwhile, act as elder statesmen for the search fund community and both personally hold positions in such vehicles, believing strongly in the model after having personal success with it. “[We give] a lot of encouragement because we know that when they’re out there doing this, it’s a roller coaster, high points and low points, and we want to make sure that they understand that that’s just part of it, that they’ll be successful as long as they’re persistent,” says Riedinger.

Their actions have guided searchers from as far away as Europe, explains Johnson, who says that within his first two years at IESE Business School, a branch of Spain’s University of Navarra, he had a London student named Simon Webster follow in Turner and Riedinger’s footsteps. “[He] was going on exchange to Columbia [University] and was interested in running his own business. I gave him the Kirk and Jamie case, ” Upon returning to London, Webster was captivated by the story and went on to engage in the first funded search in Europe in 1991, raising £80,000 ($127,000). Johnson says the student subsequently bought a family-owned prosthetics manufacturer in Leeds, U.K., called RSL (now known as RSLSteeper) for £3 million in 1992. He ran that for about seven years, according to Johnson. Webster acquired the
company when it had about £3 million in revenue. When he sold the business in 2005, revenue stood at £30 million. E rose from £400,000 to £3.4 million over the period. Webster remained CEO until 2007.

Roughly 50 search funds were launched in the past three years, with each consecutive year marking a new high, according to a study released last July by Stanford. Grousbeck, Riedinger and others, however, expect search funds to remain a little-known realm of finance. Turner, for his part, holds reservations about the future of search funds if they ever become ubiquitous. “You wonder if things get too popular, is it cresting?” he asks.

No matter the model’s future, Turner and Riedinger stand at the head of the class of the cloistered search fund community. The group is so minuscule and tight-knit that it has become an almost secret society dubbed “the search fund mafia,” a nickname that also speaks to the collective power these investors possess to curse or bless fundraising prospects. It is fitting that their journey with Alta College would serve to school other young finance professionals in an alternate path toward business leadership.

“They deserve accolades,” says Johnson. “They were pioneers.”
Glossary

**AcquiredCo**
The business that results from the EA.

**Asset Sale**
An acquisition in which only assets are acquired (as opposed to acquiring a legal entity).

**Deal Flow**
The stream of opportunities that an entrepreneur generates and evaluates during the search process.

**Entrepreneurial Acquisition (EA)**
The process of purchasing an entrepreneurial opportunity rather than inventing one.

**IRR**
Internal rate of return.

**Hard Committed Capital**
Capital that is committed by the investors and available to the entrepreneur on demand.

**Management Buy-in (MBi)**
Management Buy-in is the purchase of a business by an outside team of managers who have found financial backers and plan to actively manage the business themselves.[6]

**Private Equity (PE)**
A medium to long-term finance provided in return for an equity stake in potentially high-growth companies, which are usually, but not always, unquoted.[3]

**Search Capital**
The funds raised to finance the search phase of the search fund.

**SearchCo**
See Search Vehicle.

**Search Domain**
The chosen combination of geographic region and industries of focus for a search fund.

**Search Fund**
For the purposes of this note, a search fund is defined as *an investment vehicle that finances an entrepreneur’s efforts to locate, acquire, manage and grow an entrepreneurial opportunity.*

**Search Vehicle**
The legal structure that a searcher uses during the search phase.

**Searcher**
An entrepreneur who is looking for an entrepreneurial opportunity to acquire.

**Seller Financing**
Financing provided by the seller to finance an acquisition. Often in the form of a loan.
Soft Committed Capital

Capital that is implicitly committed, but still at the discretion of the investors. The acquisition capital of a search fund is soft committed capital – the investors have the right, but not the obligation, to participate in the acquisition. However, they have funded the search phase, which implies that they are likely to participate in the resulting acquisition.

References


